





Control Number: 51415




Item Number: 1

Addendum StartPage: 0

3. Under the circumstances described above, any reduction in Taxpayer's tax expense element of cost of service to reflect the tax benefit of its NOLC would be inconsistent with the requirements of  § 168(i)(9) and  § 1.167(l)-1.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above

This ruling is directed only to the taxpayer who requested it.  Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Peter C. Friedman

Senior Technician Reviewer, Branch 6

Office of Associate Chief Counsel

(Passthroughs & Special Industries)

cc: [Redacted Text]

Checkpoint Contents

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2017

PLR/TAM 201709023 - 201709001

PLR 201709008 -- IRC Sec(s). 167; 168, 03/03/17

## Private Letter Rulings

### Private Letter Ruling 201709008, 03/03/17, IRC Sec(s). 168

UIL No. 167.22-01

**Accelerated cost recovery  
system-normalization-accumulated deferred income tax-net  
operating loss carryforward-limitations on reasonable  
allowance in case of property of public utilities.**

#### Headnote:

In order to avoid violation of Code Sec. 168(i)(9); 's and Reg § 1.167(l)-1 's normalization requirements, it was necessary to include in regulated integrated electric utility/sub.'s rate base ADIT asset resulting from NOL carryforward, given inclusion in rate base of full amount of ADIT liability resulting from accelerated tax depreciation.

**Reference(s):** Code Sec. 168; Code Sec. 167;

#### Full Text:

Number: **201709008**

Release Date: 3/3/2017

Index Number: 167.22-01

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact: [Redacted Text]

[Redacted Text], ID No.

Telephone Number: [Redacted Text]

Refer Reply To:

CC:PSI:B06

PLR-119381-16

Date:

December 02, 2016

**LEGEND:**

Taxpayer =

Parent =

State =

Commission A =

Commission B =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Case =

Year 1 =

Year 2 =

Director =

Dear [Redacted Text]:

This letter responds to the request, dated June 15, 2016, submitted by Parent on behalf of Taxpayer for a ruling on the application of the normalization rules of the Internal Revenue Code to certain accounting and regulatory procedures, described below.

The representations set out in your letter follow.

Taxpayer is an integrated electric utility headquartered in State. Taxpayer is a wholly owned subsidiary of Parent and is included in Parent's consolidated federal income tax return. Taxpayer employs the accrual method of accounting and reports on a calendar year basis.

Taxpayer's business includes retail electric utility operations regulated within State by Commission A and Taxpayer is subject to the regulatory jurisdiction of Commission B with respect to terms and conditions of its wholesale electric transmission service and as to the rates it may charge for the provision of such services. Taxpayer's rates are established on a cost of service basis.

On Date 1, Taxpayer filed a rate case application (Case) with Commission B requesting authorization to change from charging stated rates for wholesale electric transmission service to a formula rate mechanism pursuant to which rates for wholesale transmission service are calculated annually in accordance with an approved formula. The proposed formula consisted of updating cost of service components, including investment in plant and operating expenses, based on information contained in Taxpayer's annual financial report filed with Commission B, as well as including projected transmission capital projects to be placed into service in the following year. The projections included are subject to true-up in the following year's formula rate.

In computing its income tax expense element of cost of service, the tax benefits attributable to accelerated depreciation were normalized and were not flowed thru to ratepayers.

In its rate case filing, Taxpayer anticipated that it would claim accelerated depreciation, including "bonus depreciation" on its tax returns to the extent that such depreciation was available. Taxpayer incurred a net operating loss (NOL) in each of Year 1 through Year 2 due to Taxpayer's claiming bonus depreciation, producing a net operating loss carryover (NOLC).

On its regulatory books of account, Taxpayer "normalizes" the differences between regulatory depreciation and tax depreciation. This means that, where accelerated depreciation reduces taxable income, the taxes that a taxpayer would have paid if regulatory depreciation (instead of accelerated tax depreciation) were claimed constitute "cost-free capital" to the taxpayer. A taxpayer that normalizes these differences, like Taxpayer, maintains a reserve account showing the amount of tax liability that is deferred as a result of the accelerated depreciation. This reserve is the accumulated deferred income





tax (ADIT) account. Taxpayer maintains an ADIT account. In addition, Taxpayer maintains an offsetting series of entries - a "deferred tax asset" and a "deferred tax expense" - that reflect that portion of those 'tax losses' which, while due to accelerated depreciation, did not actually defer tax because of the existence of a NOLC.

In the setting of utility rates by Commission B, a utility's rate base is offset by its ADIT balance. In its rate case filing, Taxpayer maintained that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax due to the presence of the NOLC, as represented in the deferred tax asset account. Thus, Taxpayer argued that the rate base should be reduced by its federal ADIT balance net of the deferred tax asset account attributable to the federal NOLC. It based this position on its determination that this net amount represented the true measure of federal income taxes deferred on account of its claiming accelerated tax depreciation deductions and, consequently, the actual quantity of "cost-free" capital available to it. It also asserted that the failure to reduce its rate base offset by the deferred tax asset attributable to the federal NOLC would be inconsistent with the normalization rules.

On Date 2, Commission B issued an order accepting Taxpayer's revisions to its rates. On Date 3, new rates went into effect, subject to refund. Several intervenors submitted challenges to the rate case and on Date 4, Taxpayer and those intervenors entered into a Settlement Agreement, which was filed with Commission B. On Date 5, Commission B issued an order accepting the Settlement Agreement, which allows for the inclusion of the ADIT related to the NOLC asset in rate base.

Commission B further stated in the order that it is the intent of Commission B that Taxpayer comply with the normalization method of accounting and tax normalization regulations. The order also requires Taxpayer to seek a private letter ruling (PLR) from the Service regarding Taxpayer's treatment of the ADIT related to the NOLC asset. Commission B also noted that after the Service issues a PLR, Taxpayer shall adjust, to the extent necessary, its ratemaking treatment of the ADIT related to the NOLC asset prospectively from the date of the PLR.

Taxpayer requests that we rule as follows:

1. In order to avoid a violation of the normalization requirements of  § 168(i)(9) and  Treasury Regulation § 1.167(l)-1, it is necessary to include in rate base the Accumulated Deferred Income Tax (ADIT) asset resulting from the Net Operating Loss Carryforward (NOLC), given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.
2. The exclusion from rate base of the entire ADIT asset resulting from the NOLC, or the inclusion in rate base of a portion of that ADIT asset that is less than the amount attributable to accelerated tax depreciation, computed on a "with and without" basis, would violate the normalization requirements of  § 168(i)(9) and  § 1.167(l)-1.

## Law and Analysis

Section 168(f)(2) of the Code provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under § 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under § 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base.

Former § 167(l) generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of accounting." A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A).

Section 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should

reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount



of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.





Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Regarding the first issue, § 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the reserve account for deferred taxes (ADIT), reduces rate base, it is clear that the portion of the net operating loss carryover (NOLC) that is attributable to accelerated depreciation must be taken into account in calculating the amount of the ADIT account balance. Thus, the order by Commission to include in rate base the ADIT asset resulting from the NOLC, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation is in accord with the normalization requirements.

Regarding the second issue, § 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. The "with or without" methodology employed by Taxpayer is specifically designed to ensure that the portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of "flow through" of the benefits of accelerated


depreciation to ratepayers. Under these specific facts, any method other than the "with or without" method would not provide the same level of certainty and therefore the use of any other methodology in computing the portion of the ADIT asset attributable to accelerated depreciation is inconsistent with the normalization rules

We rule as follows:

1. In order to avoid a violation of the normalization requirements of  § 168(i)(9) and  Treasury Regulation § 1.167(l)-1, it is necessary to include in rate base the Accumulated Deferred Income Tax (ADIT) asset resulting from the Net Operating Loss Carryforward (NOLC), given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.
2. The exclusion from rate base of the entire ADIT asset resulting from the NOLC, or the inclusion in rate base of a portion of that ADIT asset that is less than the amount attributable to accelerated tax depreciation, computed on a "with and without" basis, would violate the normalization requirements of  § 168(i)(9) and  § 1.167(l)-1.

This ruling is based on the representations submitted by Taxpayer and is only valid if those representations are accurate. The accuracy of these representations is subject to verification on audit.

Except as specifically determined above, no opinion is expressed or implied concerning the Federal income tax consequences of the matters described above.

This ruling is directed only to the taxpayer who requested it.  Section 6110(k)(3) of the Code provides it may not be used or cited as precedent. In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter ruling to the Director.

Sincerely,

Patrick S. Kirwan

Chief, Branch 6

Office of the Associate Chief Counsel

(Passthroughs & Special Industries)

cc: [Redacted Text]

## Internal Revenue Service

Number: **202010002**

Release Date: 3/6/2020

Index Number: 168.24-01

Department of the Treasury  
Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To

CC:PSI:B06

PLR-113227-19

Date: December 3, 2019

In Re:

### LEGEND:

Taxpayer =

Parent =

State A =

State B =

Commission =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

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Date 10 =

Date 11 =

Date 12 =

Date 13 =

Date 14 =

Date 15 =

Date 16 =

Month 1 =

Month 2 =

Month 3 =

Month 4 =

Month 5 =

Month 6 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

a =

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c =

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e =

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3

f =

g =

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k =

l =

Dear :

This letter responds to a request for a private letter ruling dated June 5, 2019, and submitted on behalf of Taxpayer for rulings under § 168(i)(9) of the Internal Revenue Code and § 1.167(l)-1 of the Income Tax Regulations (together, the “Normalization Rules”) regarding the scope of the deferred tax normalization requirements and the appropriate methodology for the reduction of the accumulated deferred income tax (“ADIT”) balance that decreases rate base computation when a net operating loss carryforward (“NOLC”) exists. The relevant facts as represented in your submission are set forth below.

#### FACTS

Taxpayer files a consolidated federal income tax return on a calendar year basis with its affiliates, including its Parent. Taxpayer uses the accrual method of accounting.

Parent is incorporated in State A, and Taxpayer is incorporated in State B. Parent is a water and wastewater utility company. Taxpayer is the affiliate that operates in State B. Prices charged by Taxpayer are set by Commission. Commission sets rates that Taxpayer may charge for the furnishing or sale of water or sewage disposal services through a combination of periodic general rate case proceedings (resulting in what are commonly referred to as “base rates”) and infrastructure surcharge proceedings (resulting in surcharges that are added to base rates.)

The most recent two base rate changes resulting from general rate case authorizations by Commission affecting water and wastewater revenue requirements were effective in Month 1 Year 1 and Month 2 Year 2. The most recent three rate changes resulting from infrastructure surcharge authorizations by Commission were effective in Month 3 Year 3, Month 4 Year 4 and Month 4 Year 2. Taxpayer questions whether the rates set pursuant to the most recent infrastructure surcharge proceeding comply with the deferred tax normalization requirements.

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Infrastructure surcharges are regulatory mechanisms to permit recovery of capital investments and results in adjustments to rates charged outside of a general rate case for specified costs and investments. Under State B statute and Commission rulemaking, eligible water corporations may petition Commission and utilize a Infrastructure System Replacement Surcharge ("Surcharge") to recover the costs of eligible water utility main replacements and relocations.

For both general rate case proceedings and Surcharge proceedings, Taxpayer computes a revenue requirement subject to Commission approval based on recovery of a debt- and equity-based return on investment in rate base, including the cost of plant assets less accumulated book depreciation and ADIT, and a recovery of operating expenses, including depreciation expense, property tax expense, and income tax expense. For Surcharge proceedings, rate base is determined based on incremental plant expenditures incurred during a historical measurement period (not necessarily 12 months) ending shortly before rates become effective, less accumulated book depreciation and ADIT computed as of a date subsequent to the date at which gross plant is computed and closer to (but preceding) the date that rates become effective. For Surcharge proceedings, operating expenses include 12 months of annualized depreciation expense on the incremental investment in the Surcharge proceeding and any property taxes that will be paid within 12 months of filing the Surcharge application.

The deferred tax normalization matters in this request arose during the Surcharge proceeding initiated by Taxpayer in Month 5 Year 2 and resulting in a Commission order on Date 1 (the "Surcharge Case"). The Surcharge resulting from the Surcharge Case became effective on Date 2. Some of the normalization matters addressed in this ruling request related to deductions and ADIT resulting from the consent agreement that Parent received from the Service on Date 3, on behalf of itself and various affiliates, including Taxpayer, with respect to changes in tax method of accounting for costs to repair and maintain tangible property and dispositions of certain tangible depreciable property ("Consent Agreement").

State B statutes and Commission B rules provide eligible water corporations with the ability to recover certain infrastructure system replacement costs outside of a formal rate case filing via a Surcharge. A petition must be filed with the Commission for review and approval before an adjustment can be made to a water corporation's rates and charges to provide for the recovery of the costs associated with eligible infrastructure system replacements. A State B statute authorizes Commission to enter an order authorizing the water corporation to impose a Surcharge that is sufficient to recover appropriate pretax revenues. The State B statute defines the revenue requirement set in a Surcharge proceeding and provides that "appropriate pretax revenues" are the revenues necessary to produce net operating income equal to the water corporation's weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system

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replacements. . .” among other items. Taxpayer represents that Commission and the State B courts have interpreted this statute in a strict manner thereby limiting the costs eligible for recovery or to earn a return in a Surcharge proceeding and causing costs not eligible for ratemaking consideration in a Surcharge proceeding to only be eligible for recovery or return in the next base rate proceeding.

Taxpayer, per its petition filed with Commission on Date 4, sought to establish a Surcharge rate to provide for the recovery of actual costs for eligible infrastructure system replacements and relocations from Date 5 through Date 6, and estimated investment accounts for Date 7 through Date 8. During the course of the Surcharge case, Taxpayer provided Commission with actual expenditures for Month 5 and Month 6. The proposed Surcharge rate schedule reflected the pre-tax Surcharge revenues necessary to produce net operating income equal to Taxpayer’s weighted cost of capital multiplied by the original cost of the requested infrastructure replacements that are eligible for the Surcharge, reduced by net ADIT and accumulated depreciation associated with eligible infrastructure system replacements through Date 9. Taxpayer also sought to recover all state, federal and local income or excise taxes applicable to such Surcharge income and to recover all other Surcharge costs including annualized depreciation expense and property taxes due within 12 months.

The specific test period and service period information pertaining to the Surcharge Case is:

- Rates became effective Date 2
- Actual gross plant was based on additions of certain property placed in service from Date 5 through Date 8
- Accumulated depreciation on such assets was estimated through Date 9
- Estimated ADIT related to depreciation book/tax differences associated with such expenditures to the extent also capitalized for tax purposes was computed through Date 9
- Estimated ADIT related to repair book/tax differences associated with such expenditures to the extent not capitalized for tax purposes was computed through Date 9
- Recoverable operating expenses were estimated for the period beginning Date 10 and ending Date 9

In a Surcharge proceeding, replacement mains and associated valves and hydrants comprise the plant assets included in rate base and result in the accumulated depreciation reducing rate base and the recoverable depreciation expense. The expenditures for replacement mains and associated valves addressed in a Surcharge proceeding are capitalizable for regulatory accounting purposes, but may result in a repair deduction for tax purposes or depreciable plant for tax purposes. The ADIT balance reducing rate base in a Surcharge proceeding is caused by depreciation-related and repair-related book/tax differences.

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The key issues in the Surcharge case and, thus, in this ruling request, pertain to whether the tax effect of an NOLC must, pursuant to the normalization requirements, decrease the ADIT reduction to rate base related to the expenditures in the Surcharge case and, if so, the methodology to determine the amount of the NOLC adjustment subject to the normalization requirements. The return on rate base is based on the pre-tax rate of return authorized in the most recent rate order resulting from a general rate proceeding.

In the course of the Surcharge Case, Taxpayer and other participants in the proceeding analyzed the expenditures for which Taxpayer sought recovery via the Surcharge and debated the proper regulatory treatment of Taxpayer's NOLC and tax loss incurred through the rate base determination date of the Surcharge case with respect to the costs incurred that are recoverable in the Surcharge case. The revenue requirement approved in Commission's order issued on Date 1 was lower than the revenue requirement sought by Taxpayer and is entirely attributable to differing ADIT calculations with respect to the NOLC and the resulting effects on rate base and allowed return. The approved revenue requirement in the Surcharge case was based on a rate base computation that reflects the gross ADIT liabilities associated with depreciation-related and repair-related book/tax differences, but did not reflect an ADIT asset for any portion of Taxpayer's NOLC as of the date that rate base was determined (Date 9) , including the tax loss resulting from the infrastructure expenditures addressed in the Surcharge Case.

On a consolidated basis, Parent incurred tax losses in various years from Year 5 to Year 1 and, as of Date 11, had an NOLC of approximately \$a. On a separate company basis, Taxpayer incurred tax losses in various tax years from Year 5 – Year 1 and, as of Date 11, had a separate company NOLC of approximately \$b. For Year 2, Parent (on a consolidated basis) and Taxpayer (on a separate company basis) estimate that taxable income was earned and, thus, NOLC was utilized.

The revenue requirement related to the Surcharge Case is approximately \$c (pursuant to the rate order). Taxpayer asserts that the revenue requirement should have been computed to be \$d. The difference in the revenue requirement computations relates entirely to the exclusion of Taxpayer's NOLC from rate base. As of the date of the rate base determination, none of the Surcharge revenues had been billed to customers and, thus, as of such date, a taxable loss of approximately \$e had been incurred with respect to the plant-related expenditures with rates set by the Surcharge Case.

During the loss years resulting in Taxpayer's NOLC estimated as of the end of the test period for the Surcharge Case, separate company deductible depreciation-related book/tax differences were approximately \$f and separate company deductible repair-related book/tax differences were approximately \$g (plus the § 481(a) adjustment with respect to the tax accounting method changes subject to the Consent agreement deducted in Year 5 of approximately \$h).



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The NOLC reflected in ratemaking for the base rate case proceeding with rates effective in Month 2 Year 2 was based on the estimated NOLC as of the end of Year 4 of \$j, including an estimated Year 4 tax loss of \$j. The actual Year 4 tax loss reported on the Year 4 tax return was \$k. The excess of the actual Year 4 tax loss over the estimated Year 4 tax loss of \$l has yet to be reflected in ratemaking.

On Date 12, Taxpayer filed an Application for Rehearing and Motion to Defer Ruling, asking the Commission for the time to seek a private letter ruling form of guidance from the Service to address any uncertainties regarding the application of the deferred tax normalization requirements to the rate base treatment of the NOLC-related ADIT asset in computing the Surcharge case revenue requirement. On Date 13, the Commission denied Taxpayer's request for rehearing. Taxpayer filed a notice of appeal by Date 14, that initiated an appeal of the order in the Surcharge case to the State B Court of Appeals. Taxpayer anticipates receiving a private letter ruling from the Service prior to the State B Court of Appeals issuing a final opinion in Taxpayer's appeal of the Commission denial of Taxpayer's Motion for Rehearing. If the Service rules that the Commission's decision in Taxpayer's Surcharge case ordered a method of regulatory accounting that is inconsistent with the deferred tax normalization requirements, Taxpayer believes that the Commission and Taxpayer would be procedurally able to correct the revenue requirement in a manner that compensates Taxpayer for any foregone revenue requirement relative to ADIT and rate base computations that comply with the normalization requirements.

Because Taxpayer is concerned that the order issued by Commission as part of the Surcharge case on Date 1, and the prices that became effective on Date 2, are inconsistent with the deferred tax normalization requirements, Taxpayer submitted a letter to the Service on Date 14 intended to provide the notification pursuant to § 1.167(l)-1(h)(5) of the Regulations.

As noted, on Date 3, Taxpayer's parent corporation received the Consent Agreement from the Internal Revenue Service granting certain of its subsidiaries, including Taxpayer, permission to change their (1) method of accounting for costs to repair and maintain tangible property from capitalizing and depreciating these costs to deducting these costs under § 162 of the Internal Revenue Code, and (2) unit of property for determining dispositions of depreciable network assets from using a method other than the functional interdependence test to using the functional interdependence test to determine the units of property. These changes in methods of accounting were effective for the taxable year beginning Date 15, and ended Date 16 (the "year of change").

These changes in methods of accounting resulted in an overall net negative § 481(a) adjustment for Taxpayer as stated in the Consent Agreement. This overall net negative § 481(a) adjustment consists of a net negative § 481(a) adjustment for the

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repair and maintenance change in method of accounting and a net positive § 481(a) adjustment for the disposition change in method of accounting.

The Service's consent to the above changes in methods of accounting is subject to several terms and conditions stated in the Consent Agreement. Condition nine of the Consent Agreement requires that if any item of property subject to the taxpayer's Form 3115 is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A): (A) a normalization method of accounting (within the meaning of § 168(i)(9), former § 168(e)(3)(B), or former § 167(l)(3)(G), as applicable) must be used for the public utility property subject to the Form 3115; (B) as of the beginning of the year of change, the taxpayer must adjust its deferred tax reserve account or similar reserve account in the taxpayer's regulatory books of account by the amount of the deferral of federal income tax liability associated with the § 481(a) adjustment applicable to the public utility property subject to the Form 3115; and (C) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer must provide a copy of the Form 3115 (and any additional information submitted to the Service in connection with such Form 3115) to any regulatory body having jurisdiction over the public utility property subject to the Form 3115. See page 6 of the Consent Agreement.

Based on Taxpayer's interpretation of this condition in the Consent Agreement, Taxpayer has applied the normalization requirements to its repair-related and disposition-related deferred tax computations in rate proceedings since the year of change.

Prior to the year of change (Year 5), Taxpayer depreciated public utility property that was in service as of the end of the taxable year immediately preceding the year of change using different book and tax methods and lives. As a result, an amount of ADIT subject to the normalization requirements was recorded prior to the above changes in methods of accounting for repairs and dispositions (depreciation-related ADIT).

Differing assertions were made as part of the Surcharge Case. Ultimately the Commission in its final order determined that because there was not an NOL expected to be generated in Year 4, no portion of the NOLC deferred tax asset can be associated with the Surcharge property.

#### RULINGS REQUESTED

1) The property otherwise depreciable under § 168(a) and for which cost recovery and return on investment initially occur as part of the Surcharge Case, rather than as part of base rates set in less frequent general rate case proceedings, constitutes public utility property within the meaning of § 168(i)(10).

2) The ADIT amounts used in computing the revenue requirement set in the Surcharge Case with respect to public utility property within the meaning of § 168(i)(10)

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must comply with the normalization method of accounting within the meaning of § 168(i)(9).

3) For any public utility property within the meaning of § 168(i)(10) as of the end of the tax year immediately preceding the year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement, the depreciation-related ADIT prior to the change in tax method of accounting for repairs and dispositions remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax method of accounting.

4) For any public utility property within the meaning of § 168(i)(10) and subject to Taxpayer's Consent Agreement, the ADIT resulting from the repair-related § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

5) The ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

6) The ADIT resulting from book/tax differences related to depreciable method and life for public utility property that exists at the date of a retirement of the property for regulatory accounting purposes in a transaction involving a replacement or relocation that is not treated as a disposition under Taxpayer's tax method of accounting for dispositions permitted in Taxpayer's Consent Agreement remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after the book-only retirement.

7) For any public utility property within the meaning of § 168(i)(10) for which a disposition had been recognized for tax purposes in a tax year prior to the tax year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement and for which the taxable gain or loss upon such disposition was reversed as part of the disposition-related § 481(a) adjustment, the ADIT related to the restored tax basis of such public utility property is subject to the normalization method of accounting within the meaning of § 168(i)(9), despite the book-only retirement.

8) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: In order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the

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revenue requirement set in the Surcharge Case is limited to the amount of depreciation-related deferred tax expense recovered in rates as of the Surcharge Case rate base determination date.

9) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOL for the test period for the Surcharge Case which would not have arisen had Taxpayer not reported depreciation-related book/tax differences during the test period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method.

10) If the Service (a) rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, but (b) does not grant ruling # 9 in accordance with Taxpayer's analysis, Taxpayer requests that the Service instead rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences during the test period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method but only to the extent that the NOLC has not reduced depreciation-related ADIT in rate base computation in another rate proceeding with prices still in effect.

11) If the Service rules as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is not subject to the normalization requirements, Taxpayer requests that the Service also rule: Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), it is not necessary to decrease ADIT or otherwise increase rate base for the Surcharge Case by the portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences in prior periods or during the test period for the Surcharge Case with respect to public utility property with rates not set by the Surcharge Case.

12) If the Service does not rule as Taxpayer has requested with respect to issue # 5 and holds that ADIT resulting from repair-related book/tax differences is subject to the normalization requirements, Taxpayer requests that the Service also rule: Under

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the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect the portion of the Surcharge Case test period NOL which would not have arisen had Taxpayer not reported the depreciation-related book/tax difference or repair-related book/tax difference permitted in Taxpayer's Consent Agreement with respect to expenditures with ratemaking determined pursuant to the Surcharge Case, by an amount that is no less than the amount computed using the With-and-Without Method. If, instead, the Service rules as Taxpayer has requested with respect to issue # 5, ruling request # 12 would be moot.

### LAW AND ANALYSIS

Section 168(f)(2) provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

Section 168(i)(10) defines, in part, public utility property as property used predominantly in the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof.

Prior to the Revenue Reconciliation Act of 1990, the definition of public utility property was contained in § 167(l)(3)(A) and § 168(i)(10), which defined public utility property by means of a cross reference to § 167(l)(3)(A). The definition of public utility property is unchanged. Section 1.167(l)-1(b) provides that under § 167(l)(3)(A), property is public utility property during any period in which it is used predominantly in a § 167(l) public utility activity. The term "section 167(l) public utility activity" means, in part, the trade or business of the furnishing or sale of electrical energy if the rates for such furnishing or sale, as the case may be, are regulated, i.e., have been established or approved by a regulatory body described in § 167(l)(3)(A). The term "regulatory body described in § 167(l)(3)(A)" means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term "established or approved" includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer.

The definitions of public utility property contained in § 168(i)(10) and former § 46(f)(5) are essentially identical. Section 1.167(l)-1(b) restates the statutory definition providing that property will be considered public utility property if it is used predominantly in a public utility activity and the rates are regulated. Section 1.167(l)-1(b)(1) provides that rates are regulated for such purposes if they are established or approved by a regulatory body. The terms established or approved are further defined

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to include the filing of a schedule of rates with the regulatory body that has the power to approve such rates, even if the regulatory body has taken no action on the filed schedule or generally leaves undisturbed rates filed.

The regulations under former § 46, specifically § 1.46-3(g)(2), expand the definition of regulated rates. The expanded definition embodies the notion of rates established or approved on a rate of return basis. This notion is not specifically provided for in the regulations under former § 167. Nevertheless, there is an expressed reference to rate of return in § 1.167(l)-1(h)(6)(i). The operative rules for normalizing timing differences relating to use of different methods and periods of depreciation are only logical in the context of rate of return regulation. The normalization method, which must be used for public utility property to be eligible for the depreciation allowance available under § 168, is defined in terms of the method the taxpayer uses in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account. Thus, for purposes of applying the normalization rules, the definition of public utility property is the same for purposes of the investment tax credit and depreciation.

Section 168(f)(2) of the Code provides that the depreciation deduction determined under § 168 shall not apply to any public utility property (within the meaning of § 168(i)(10)) if the taxpayer does not use a normalization method of accounting.

In order to use a normalization method of accounting, § 168(i)(9)(A)(i) requires the taxpayer, in computing its tax expense for establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, to use a method of depreciation with respect to public utility property that is the same as, and a depreciation period for such property that is not shorter than, the method and period used to compute its depreciation expense for such purposes. Under § 168(i)(9)(A)(ii), if the amount allowable as a deduction under § 168 differs from the amount that would be allowable as a deduction under § 167 using the method, period, first and last year convention, and salvage value used to compute regulated tax expense under § 168(i)(9)(A)(i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

Section 168(i)(9)(B)(i) provides that one way the requirements of § 168(i)(9)(A) will not be satisfied is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with such requirements. Under § 168(i)(9)(B)(ii), such inconsistent procedures and adjustments include the use of an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under § 168(i)(9)(A)(ii), unless such estimate or projection is also used, for ratemaking purposes, with respect to all three of these items and with respect to the rate base (referred to as the "Consistency Rule").

Former § 167(l) generally provided that public utilities were entitled to use accelerated methods for depreciation if they used a "normalization method of

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accounting.” A normalization method of accounting was defined in former § 167(l)(3)(G) in a manner consistent with that found in § 168(i)(9)(A). Section 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. These regulations do not pertain to other book-tax timing differences with respect to state income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items.

Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes.

Section 1.167(l)-1(h)(1)(iii) provides that the amount of federal income tax liability deferred as a result of the use of different depreciation methods for tax and ratemaking purposes is the excess (computed without regard to credits) of the amount the tax liability would have been had the depreciation method for ratemaking purposes been used over the amount of the actual tax liability. This amount shall be taken into account for the taxable year in which the different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (1) method for purposes of determining the taxpayer's reasonable allowance under § 167(a) results in a net operating loss carryover to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under § 167(a) using a subsection (1) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a).

Section 1.167(l)-1(h)(6)(i) provides that, notwithstanding the provisions of subparagraph (1) of that paragraph, a taxpayer does not use a normalization method of

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regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes under § 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking.

Section 1.167(l)-1(h)(6)(ii) provides that, for the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i), above, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for that period is the amount of the reserve (determined under § 1.167(l)-1(h)(2)(i)) at the end of the historical period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period.

Section 1.167(l)-1(h) requires that a utility must maintain a reserve reflecting the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Taxpayer has done so. Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Section 56(a)(1)(D) provides that, with respect to public utility property the Secretary shall prescribe the requirements of a normalization method of accounting for that section.

Section 1.167(l)-1(a)(1) of the Income Tax Regulations provides that the normalization requirements of former § 167(l) with respect to public utility property defined in former § 167(l)(3)(A) pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account.

Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when a taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. See also § 2.05(1) of Rev. Proc. 97-27,



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97-27, 1997-1 C.B. 680 (the operative method change revenue procedure at the time Taxpayer filed its Form 3115, *Application for Change in Accounting Method*).

An adjustment under § 481(a) can include amounts attributable to taxable years that are closed by the period of limitation on assessment under § 6501(a). *Suzy's Zoo v. Commissioner*, 114 T.C. 1, 13 (2000), *aff'd*, 273 F.3d 875, 884 (9th Cir. 2001); *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895, 912 (1983), *Weiss v. Commissioner*, 395 F.2d 500 (10th Cir. 1968), *Spang Industries, Inc. v. United States*, 6 Cl. Ct. 38, 46 (1984), *rev'd on other grounds* 791 F.2d 906 (Fed. Cir. 1986). *See also Mulholland v. United States*, 28 Fed. Cl. 320, 334 (1993) (concluding that a court has the authority to review the taxpayer's threshold selection of a method of accounting *de novo*, and must determine, *ab initio*, whether the taxpayer's reported income is clearly reflected).

Sections 481(c) and 1.481-4 provide that the adjustment required by § 481(a) may be taken into accounting in determining taxable income in the manner, and subject to the conditions, agreed to by the Service and a taxpayer. Section 1.446-1(e)(3)(i) authorizes the Service to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e). *See also* § 5.02 of Rev. Proc. 97-27.

When there is a change in method of accounting to which § 481(a) is applied, § 2.05(1) of Rev. Proc. 97-27 provides that income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Regarding ruling requests 1 and 2, the key factors in determining whether property is public utility property are that (1) the property must be used predominantly in the trade or business of the furnishing or sale of, *inter alia*, water and wastewater; (2) the rates for such furnishing or sale must be established or approved by a State or political subdivision thereof, any agency or instrumentality of the United States, or by a public service or public utility commission or similar body of any State or political subdivision thereof; and (3) the rates so established or approved must be determined on a rate-of-return basis. State B statutes and Commission B rules provide eligible water corporations with the ability to recover certain infrastructure system replacement costs outside of a formal rate case filing via a Surcharge. These infrastructure system replacements will be predominantly used in the trade or business of the furnishing or sale of water and wastewater and therefore, it will possess the first of the three characteristics. Moreover, as a regulated public utility subject to the jurisdiction of federal or state law, including the ratemaking jurisdiction of the State B commission, the second requirement is met. Lastly, as evidenced by the facts, these rates are determined on a rate-of-return basis. After establishing that this involves public utility property, the law makes clear that the depreciation deduction determined under § 168

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shall not apply to any public utility property if the taxpayer does not use a normalization method of accounting. The normalization regulations require a taxpayer to credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account.

Taxpayer's ruling request 3 pertains to the depreciation-related ADIT existing prior to the year of change ( ) for public utility property in service as of the end of the taxable year immediately preceding the year of change. Beginning with the year of change, the Consent Agreement granted Taxpayer permission to change its (1) method of accounting for costs to repair and maintain tangible property from capitalizing and depreciating these costs to deducting these costs under § 162, and (2) unit of property for determining dispositions of depreciable network assets from using a method other than the functional interdependence test to using the functional interdependence test to determine the units of property.

As stated previously, condition nine of the Consent Agreement provides that if any item of property subject to the Form 3115 is public utility property within the meaning of § 168(i)(10), a normalization method of accounting (within the meaning of § 168(i)(9)) must be used for such public utility property. Public utility property (within the meaning of § 168(i)(10)) is a depreciable asset. Consequently, condition nine of the

Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years.

When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed by Taxpayer, and income for the year of change and the following taxable years must be determined under Taxpayer's new method of accounting as if the new method had always been used. See § 481(a); § 1.481-1(a)(1); and § 2.05(1) of Rev. Proc. 97-27. In other words: (1) Taxpayer's new method of accounting is implemented beginning in the year of change; (2) Taxpayer's old method of accounting used in the taxable years preceding the year of change is not disturbed; and (3) Taxpayer takes into account a § 481(a) adjustment in computing taxable income to offset any consequent omissions or duplications.

Accordingly, for public utility property in service as of the end of the taxable year immediately preceding the year of change ( ), the depreciation-related ADIT existing prior to the year of change for the changes in methods of accounting subject to the Consent Agreement does not remain subject to the normalization method of accounting within the meaning of § 168(i)(9) after implementation of the new tax methods of accounting in the year of change and subsequent taxable years.

As stated previously under ruling request 3, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of

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accounting for the year of change and subsequent taxable years. A repair expense is an item of expense that is deductible under § 162 and for which depreciation is not allowable. Accordingly, the ADIT resulting from the repair-related § 481(a) adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

Similarly, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. A repair expense is an item of expense that is deductible under § 162 and for which depreciation is not allowable. Accordingly, ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

Regarding ruling request 6, § 1.167(l)-1(a)(1) provides that the normalization requirements for public utility property pertain only to the deferral of federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under § 167 and the use of straight-line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Section 1.167(l)-1(h)(1)(i) provides that the reserve established for public utility property should reflect the total amount of the deferral of federal income tax liability resulting from the taxpayer's use of different depreciation methods for tax and ratemaking purposes. Section 1.167(l)-1(h)(2)(i) provides that the taxpayer must credit this amount of deferred taxes to a reserve for deferred taxes, a depreciation reserve, or other reserve account. This regulation further provides that, with respect to any account, the aggregate amount allocable to deferred tax under § 167(1) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation. That section also notes that the aggregate amount allocable to deferred taxes may be reduced to reflect the amount for any taxable year by which federal income taxes are greater by reason of the prior use of different methods of depreciation under § 1.167(l)-1(h)(1)(i) or to reflect asset retirements or the expiration of the period for depreciation used for determining the allowance for depreciation under § 167(a). In this case, the transaction involves a replacement or relocation that is not treated as a disposition under Taxpayer's tax method of accounting. The depreciation-related ADIT existing immediately prior to a transaction considered a retirement for regulatory accounting purposes but not treated as a disposition for federal income tax purposes continues to be subject to the

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normalization requirements because adjusted tax basis is not affected and the § 168(a) depreciation deductions continue.

For ruling request 7, as stated previously under ruling request 3, condition nine of the Consent Agreement is intended to apply to Taxpayer's public utility property that continues to be depreciated for federal income tax purposes under Taxpayer's new method of accounting for the year of change and subsequent taxable years. Accordingly, the ADIT resulting from the disposition-related § 481(a) adjustment and related to the restored tax basis of public utility property that was treated as disposed under the old method of accounting but is not treated as disposed under the new method of accounting is subject to the normalization method of accounting within the meaning of § 168(i)(9).

Regarding ruling requests 8, 9, and 11, generally, Taxpayer is arguing that the ADIT balance should be reduced by the amounts that Taxpayer calculates did not actually defer tax during the Surcharge Case test period due to the presence of the NOLC. The normalization requirements pertain only to deferred income taxes for public utility property resulting from the use of accelerated depreciation for tax purposes and the use of straight-line depreciation for establishing cost of service and reflecting the operating results in regulated books of account. Generally, amounts that do not actually defer tax because of the existence of an NOL need to be reflected as offsetting entries to the ADIT account to show the portion of tax losses which did not actually defer tax due to accelerated depreciation.

Section 1.167(l)-1(h)(6)(i) provides that a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes, the amount of the reserve for deferred taxes which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's expense in computing cost of service in such ratemaking. Because the reserve account for deferred taxes (ADIT), reduces rate base, it is clear that the portion of the net operating loss carryover (NOLC) that is attributable to accelerated depreciation must be taken into account in calculating the amount of the ADIT account balance. Thus, the ADIT asset resulting from the NOLC should be included in rate base, given the inclusion in rate base of the full amount of the ADIT liability resulting from accelerated tax depreciation.

Section 1.167(l)-1(h)(1)(iii) makes clear that the effects of an NOLC must be taken into account for normalization purposes. Section 1.167(l)-1(h)(1)(iii) provides generally that, if, in respect of any year, the use of other than regulatory depreciation for tax purposes results in an NOLC carryover (or an increase in an NOLC which would not have arisen had the taxpayer claimed only regulatory depreciation for tax purposes), then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director. The "with or without" methodology suggested by Taxpayer is specifically designed to ensure that the

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portion of the NOLC attributable to accelerated depreciation is correctly taken into account by maximizing the amount of the NOLC attributable to accelerated depreciation. This methodology provides certainty and prevents the possibility of “flow through” of the benefits of accelerated depreciation to ratepayers.

Taxpayer also raises the issue of the computation of the amount by which depreciation-related Taxpayer's NOLC as of the rate base determination date for the Surcharge Case must be included in rate base. This focuses on whether the NOLC taken into account in the Surcharge Case is limited to depreciation-related book/tax differences related to expenditures reflected in the Surcharge Case or must also reflect the full net increase in depreciation-related NOLC occurring since the rate base determination date of the immediately preceding base rate proceeding. In this case, based on the State B statute, the revenue requirement of a Surcharge Case is limited to the following income tax amounts: ADIT associated with property-related costs for property with rates set by the Surcharge Case and income taxes applicable to the Surcharge Case revenue requirement. The normalization requirements do not require that all incremental NOLC arising since the most recent general rate proceeding must be reflected in an interim (here a Surcharge) proceeding. Instead, the normalization requirements permit an increase in NOLC resulting from non-Surcharge Case public utility property to be disregarded for the Surcharge Case and considered in the next rate proceeding that reflects the depreciation expense and rate base inclusion of the public utility property resulting in the depreciation-related book/tax differences included in the NOLC.

Based on the foregoing, we conclude that:

- 1) The property otherwise depreciable under § 168(a) and for which cost recovery and return on investment initially occur as part of the Surcharge Case, rather than as part of base rates set in less frequent general rate case proceedings, constitutes public utility property within the meaning of § 168(i)(10).
- 2) The ADIT amounts used in computing the revenue requirement set in the Surcharge Case with respect to public utility property within the meaning of § 168(i)(10) must comply with the normalization method of accounting within the meaning of § 168(i)(9).
- 3) For any public utility property within the meaning of § 168(i)(10) of the Code as of the end of the tax year immediately preceding the year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement, the depreciation-related ADIT prior to the change in tax method of accounting for repairs and dispositions is not subject to the normalization method of accounting within the meaning of § 168(i)(9) of the Code after implementation of the new tax method of accounting.
- 4) For any public utility property within the meaning of § 168(i)(10) and subject to Taxpayer's Consent Agreement, the ADIT resulting from the repair-related § 481(a)

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adjustment is not subject to the normalization method of accounting within the meaning of § 168(i)(9).

5) The ADIT resulting from expenditures (1) related to an item of property includible in rate base and recoverable as regulatory depreciation expense in the determination of the revenue requirement set in the Surcharge Case and (2) deducted as repairs under § 162 to public utility property within the meaning of § 168(i)(10), or a predecessor provision of the normalization requirements, pursuant to the tax method of accounting for repairs permitted in Taxpayer's Consent Agreement, is not subject to the normalization method of accounting within the meaning of § 168(i)(9) or, as applicable, a predecessor statutory provision.

6) The ADIT resulting from book/tax differences related to depreciable method and life for public utility property that exists at the date of a retirement of the property for regulatory accounting purposes in a transaction involving a replacement or relocation that is not treated as a disposition under Taxpayer's tax method of accounting for dispositions permitted in Taxpayer's Consent Agreement remains subject to the normalization method of accounting within the meaning of § 168(i)(9) after the book-only retirement.

7) For any public utility property within the meaning of § 168(i)(10) for which a disposition had been recognized for tax purposes in a tax year prior to the tax year of change for the changes in tax method of accounting subject to Taxpayer's Consent Agreement and for which the taxable gain or loss upon such disposition was reversed as part of the disposition-related § 481(a) adjustment, the ADIT related to the restored tax basis of such public utility property is subject to the normalization method of accounting within the meaning of § 168(i)(9), despite the book-only retirement.

8) In order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case is limited to the amount of depreciation-related deferred tax expense recovered in rates as of the Surcharge Case rate base determination date.

9) Under the circumstances described, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), the amount of depreciation-related ADIT reducing rate base used to determine the revenue requirement set in the Surcharge Case must be decreased to reflect a portion of the NOL for the test period for the Surcharge Case which would not have arisen had Taxpayer not reported depreciation-related book/tax differences during the test period for the Surcharge Case and such decrease in depreciation-related ADIT must be an amount that is no less than the amount computed using the With-and-Without Method.

10) Ruling request 10 is moot because we grant ruling 9 in accordance with Taxpayer's analysis.

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11) Under the circumstances described above, in order to comply with the normalization method of accounting within the meaning of § 168(i)(9), it is not necessary to decrease ADIT or otherwise increase rate base for the Surcharge Case by the portion of the NOLC which would not have arisen (or an increase in such NOLC which would not have arisen) had Taxpayer not reported depreciation-related book/tax differences in prior periods or during the test period for the Surcharge Case with respect to public utility property with rates not set by the Surcharge Case.

12) Ruling request 12 is moot because we rule as Taxpayer requests with respect to ruling request 5.

Except as specifically set forth above, no opinion is expressed or implied concerning the federal income tax consequences of the above described facts under any other provision of the Code or regulations.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

This ruling is based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Patrick S. Kirwan  
Chief, Branch 6  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

This Exhibit is HIGHLY SENSITIVE PROTECTED MATERIAL pursuant to the terms of the Protective Order. The information is available for review by eligible parties at the Austin offices of American Electric Power Company (AEP), 400 West 15th Street, Suite 1520, Austin, Texas, (512) 481-4562, during normal business hours.



### EXECUTIVE SUMMARY OF BRIAN J. FRANTZ

Brian J. Frantz, Director, Corporate Accounting, for American Electric Power Service Corporation (AEPSC) provides an overview of the affiliate costs included in Southwestern Electric Power Company's (SWEPCO or Company) case. Included in SWEPCO's cost of service are the following amounts of adjusted test year affiliate costs for services provided by AEPSC and services provided by other affiliates:

<b>Affiliate</b>	<b>Amount</b>
AEPSC	\$85,227,881
Other Affiliates	\$2,406,697
<b>Total</b>	<b>\$87,634,578</b>

The March 2020 adjusted test year affiliate costs of \$87.6 million are higher by \$12.9 million, or about 17.3%, when compared to the June 2016 adjusted test year affiliate costs of \$74.7 million included in SWEPCO's last base rate case, Docket No. 46449. Approximately \$10M of this increase is related to information technology charges, telecommunications, customer service, transmission, and generation. These increases in costs are explained further within the testimonies of Company witnesses Greg Filipkowski, Stacey Stoffer, Paul Pratt, Daniel Boezio, and Monte McMahon, respectively.

Consistent with the Public Utility Commission of Texas's (Commission) Electric Utility Rate Filing Package for Generating Utilities (RFP), SWEPCO presents affiliate costs by "Class of Service." The Company's AEPSC affiliate costs have been separated into twenty-two classes, with each class supported by a witness who is responsible for or knowledgeable about that area of service. Sixteen witnesses present testimony supporting the

twenty-two classes of AEPSC costs incurred by SWEPCO and support the reasonableness and necessity of the costs in these classes. In addition, three witnesses provide information relating to the overall reasonableness and necessity of SWEPCO's affiliate costs or to the reasonableness and necessity of specific major components of all affiliate costs, such as payroll and benefits.

Each witness also presents, as available and meaningful, cost trends, budget comparisons, staffing trends, benchmarks, and other types of evidence suggested by the RFP, for proof of the reasonableness of SWEPCO's affiliate costs.

Mr. Frantz supports the Allocation Factors utilized by AEPSC to ensure that SWEPCO pays no more than any other American Electric Power Company, Inc. (AEP) company for the services it receives from AEPSC.

Mr. Frantz describes the management and regulatory oversight of AEPSC, the primary mission of which is to provide services to the utility subsidiaries of the AEP system. Mr. Frantz notes that of the approximately \$74 billion of assets owned by AEP, approximately 90 percent are regulated affiliate assets.

Mr. Frantz describes the organization of AEPSC and its relationship with the utility operating companies and other AEP affiliates. He describes the AEP accounting system controls, management oversight process, and audit and reporting oversight. These controls ensure that AEPSC affiliate costs are billed accurately.

Mr. Frantz next addresses the standards governing the recovery of affiliate costs under Public Utility Regulatory Act (PURA) § 36.058 and other applicable standards. He also discusses the effect on a utility service company such as AEPSC of the repeal as of December

9, 2005 of the Public Utility Holding Company Act of 1935, including the transfer of certain responsibilities previously under that Act to the Federal Energy Regulatory Commission. In particular, Mr. Frantz explains the Federal Energy Regulatory Commission (FERC) requires the filing of the FERC Form No. 60 and periodically conducts audits of AEP affiliate transactions.

Mr. Frantz then describes the AEPSC accounting and billing process, including how the process establishes: (a) who should be billed; (b) how the service should be billed; and (c) what service was provided. Mr. Frantz describes the role of the benefiting location (*Who* to bill), allocation factor (*How* to bill), and work order/activity code (*What* service to bill) in tracking costs for a specific project or activity and in ensuring that the entities who are the beneficiaries of the project or activity are properly charged.

Pursuant to the work order process, SWEPCO and every other affiliate included in a given benefiting location receiving a service from AEPSC are charged the same unit price. Consistent with the requirements of PURA § 36.058(c)(2), Mr. Frantz demonstrates that the price charged by AEPSC to SWEPCO for the service at AEPSC's actual cost is no higher than the price charged to the other affiliates receiving the service.

Mr. Frantz also addresses and supports affiliate costs for services provided to SWEPCO by affiliates other than AEPSC. These charges consist of: (a) convenience payments, which are pass-through billings by one affiliate to another for services or goods provided by a third party; and (b) service payments where an affiliate provides a service to SWEPCO.

Mr. Frantz provides detailed support for the reasonableness and necessity of the services provided by AEPSC to SWEPCO during the test year for the following five classes of affiliate costs:

<b>Class of Service</b>	<b>Amount</b>
Chief Financial Officer	9,202,558
Chief Executive Officer/Internal Audit	1,215,730
Supply Chain, Procurement and Fleet Operations	334,300
Internal Support	1,274,626
AEPSC Incentives	3,999,909
<b>Total</b>	<b>16,027,123</b>

Mr. Frantz supports the reasonableness of the level of affiliate costs in these five classes, using several types of supporting data. He discusses the necessity of the services to SWEPCO's ability to provide service and the benefits SWEPCO's customers receive from these services.

Mr. Frantz concludes his testimony by describing the allocation factors that are used by AEPSC to allocate costs to each of SWEPCO's classes of service in this case and shows that each allocation factor utilized is reasonable, and allocates costs to SWEPCO fairly. By this method, Mr. Frantz demonstrates that the affiliate charges to SWEPCO are no higher than the charges to other AEP affiliates or to non-affiliates.

PUBLIC UTILITY COMMISSION OF TEXAS

APPLICATION OF  
SOUTHWESTERN ELECTRIC POWER COMPANY  
FOR AUTHORITY TO CHANGE RATES

DIRECT TESTIMONY OF  
BRIAN J. FRANTZ  
FOR  
SOUTHWESTERN ELECTRIC POWER COMPANY

OCTOBER 2020

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## EXHIBITS

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EXHIBIT BJF-2	Adjusted Affiliate Expenses
EXHIBIT BJF-3	Organization Chart
EXHIBIT BJF-4	Description of Services
EXHIBIT BJF-5	Capital Projects
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EXHIBIT BJF-14	Affiliate Payroll
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EXHIBIT BJF-18	Pro-Forma Adjustments to Affiliate Costs
EXHIBIT BJF-19	AEPSC Billing to SWEPCO March 2020
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EXHIBIT BJF-23	Chief Executive Officer, Internal Audit Class of Service
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I. INTRODUCTION

A. Introduction and Qualifications

Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.

A. My name is Brian J. Frantz. My business address is 1 Riverside Plaza, Columbus, Ohio 43215. I am currently Director, Corporate Accounting, for American Electric Power Service Corporation (AEPSC), a wholly-owned subsidiary of American Electric Power Company, Inc. (AEP).

Q. WHAT ARE YOUR PRINCIPAL AREAS OF RESPONSIBILITY WITH AEPSC?

A. I am responsible for maintaining the accounting books and records, and regulatory reporting for AEPSC. I am also responsible for AEPSC's monthly service billings to its affiliates. My responsibilities for AEPSC also include compliance with the Federal Energy Regulatory Commission's (FERC) Uniform System of Accounts accounting and reporting requirements.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND.

A. I attended Ohio University and received a Bachelor of Business Administration degree, with an emphasis in Accounting in 1999. I have been employed by AEPSC since March 2005, when I was hired as a Staff Accountant in the Wholesale Commodity Accounting group. In May 2010, I was promoted to Supervisor of the Fuel and Contract Accounting group. In August 2013, I was promoted to Administrator of Regulated Accounting. In December 2013, I was promoted to Manager Regulated Accounting where I was responsible for the books and records for



1 four operating companies (Indiana Michigan Power Company, Kentucky Power  
2 Company, Kingsport Power Company and AEP Generating Company). In November  
3 2014, I moved to become Manager Regulated Accounting, where I was responsible  
4 for AEPSC, until being promoted to my current position of Director in December  
5 2018. Prior to my employment with AEP, I spent approximately one year in a  
6 financial reporting role and five years in various roles in public accounting.

7 Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE ANY REGULATORY  
8 COMMISSIONS?

9 A. Yes, I have testified before the Corporation Commission of the State of Oklahoma  
10 (OCC) in Cause No. PUD 201500208. In addition, I submitted written testimony  
11 with the OCC in Cause Nos. PUD 201700151 and PUD 201800097, and with the  
12 Public Utility Commission of Texas (Commission) in Docket Nos. 44717, 44718,  
13 45928, 45929, 46449, 47236, 48422, and 49494.

14 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

15 A. My testimony addresses several areas, including:

- 16 • An overview of the affiliate costs included in this case, and an introduction of the  
17 Southwestern Electric Power Company (SWEPCO or the Company) witnesses  
18 who will support those costs;
- 19 • A description of the approach SWEPCO has taken to meet its burden of proof for  
20 recovery of affiliate costs;
- 21 • An explanation of how AEPSC is organized to provide services to SWEPCO and  
22 other AEP utility operating companies;
- 23 • A demonstration of the management oversight and quality assurance controls in  
24 place to ensure that affiliate billings are accurate;
- 25 • A description of the Public Utility Regulatory Act's (PURA) standards governing  
26 recovery of affiliate costs, as well as applicable Commission rules and precedent;

- 1 • A discussion of the Public Utility Holding Company Act of 2005 (PUHCA) and  
2 its impact on AEPSC;
- 3 • A discussion of the workings of AEPSC's billing system for the services it  
4 provides to SWEPCO and the other AEP utility operating companies;
- 5 • A demonstration that the allocation factors used to allocate charges from AEPSC  
6 to SWEPCO during the test year are reasonable and ensure that SWEPCO's  
7 charges are no higher than those of other AEP affiliates for the same services or  
8 types of services;
- 9 • A review and description of the charges made from SWEPCO affiliates (other  
10 than AEPSC) to SWEPCO during the test year, supporting the conclusion that  
11 those charges meet the Commission's cost recovery standards; and
- 12 • Finally, I sponsor and describe the services provided to SWEPCO by AEPSC that  
13 fall within the Chief Financial Officer class of service, the Chief Executive  
14 Officer class of service, the Supply Chain, Procurement and Fleet Operations class  
15 of service, the Internal Support class of service, and the AEPSC Incentives class  
16 of service, and how the costs associated with these services meet the standards for  
17 recovery of affiliate costs.

18 Q. DO YOU SPONSOR ANY SCHEDULES IN THE RATE FILING PACKAGE?

19 A. Yes, I sponsor, or co-sponsor Schedules F, G-4, G-4.1c1, G-4.2a1-c1, G-4.3a1-e1, G-  
20 6, G-6.1 and G-6.2 of the Electric Utility Rate Filing Package for Generating Utilities  
21 (RFP).

22 Q. WHAT OTHER EXHIBITS DO YOU SPONSOR?

23 A. I sponsor EXHIBITs BJF-1 through BJF-24 as listed in the Index to my testimony.  
24 EXHIBITs BJF-1 through EXHIBIT BJF-14 are consistent with the schedules  
25 provided in "Section V: Affiliate Data" of the Investor Owned Utility Transmission  
26 and Distribution Rate Filing Package. The Company has chosen to provide this  
27 information in order to make readily available a much greater level of detail regarding  
28 affiliate transactions. The affiliate portion of this rate case has been organized in the  
29 same manner as the prior Texas rate case filed by SWEPCO in Docket No. 46449, as

1 well as prior Texas rate cases filed by AEP affiliate AEP Texas Inc. (for example,  
2 Docket No. 49494).

3 B. Overview of SWEPCO's Affiliate Case

4 Q. PLEASE DESCRIBE THE AFFILIATE COSTS REQUESTED BY THE  
5 COMPANY.

6 A. As shown on Schedule G-6 and detailed by class on EXHIBIT BJF-15, the SWEPCO  
7 cost of service includes \$87,634,578 of affiliate operations and maintenance (O&M)  
8 costs on a total company basis, in the following categories:

9 *Table 1*

10 **SWEPCO AFFILIATE REQUEST**

Affiliate	Amount
AEPSC	\$85,227,881
Other Affiliates	\$ 2,406,697
Total	\$87,634,578

11 *Source: EXHIBIT BJF-15*

12 Q. HOW DOES THE \$87.6 MILLION OF AFFILIATE EXPENSE INCLUDED IN  
13 THIS CASE RELATE TO THE TOTAL EXPENSES FOR SWEPCO?

14 A. SWEPCO's total company expense as shown on Schedule A, lines 3 and 4 of the  
15 filing package is \$553.4 million, and the \$87.6 million of affiliate costs included in  
16 that number represents approximately 16% of the total O&M requested in this case.  
17 The remaining approximately 84% is incurred directly by SWEPCO and not through  
18 an affiliate.

19 Q. HOW DO THE AFFILIATE COSTS COMPARE TO THOSE IN DOCKET  
20 NO. 46449?

1 A. The March 2020 adjusted test year affiliate costs of \$87.6 million billed to SWEPCO  
2 are higher by \$12.9 million, or about 17.3%, when compared to the June 2016  
3 adjusted test year affiliate costs of \$74.7 million. Approximately \$10M of this  
4 increase is related to information technology charges, telecommunications, customer  
5 service, transmission, and generation. These increases in costs are explained further  
6 within the testimonies of Company witnesses Greg A. Filipkowski, Stacey L. Stoffer,  
7 Paul Pratt, Jr., Daniel R. Boezio, and Monte McMahon, respectively.

8 Q. PLEASE DESCRIBE HOW THE COMPANY HAS ORGANIZED ITS  
9 TESTIMONY REGARDING THE AFFILIATE COSTS.

10 A. SWEPCO's affiliate costs have been separated into twenty-two classes, with each  
11 class supported by a witness who is responsible for or knowledgeable about that area  
12 of service (See Table 2) below. Additionally, my testimony provides an overview of  
13 billing mechanisms that demonstrates that the charges to SWEPCO are not higher  
14 than charges to other affiliates or third parties, discusses how the accounting for  
15 affiliate costs is accomplished, and discusses the use and reasonableness of allocation  
16 factors for each class. I also support the costs from the non-AEPSC affiliates, which  
17 are primarily payments for services received from the affiliate companies.

18 The Company also engaged the consulting firm of Baryenbruch &  
19 Company, LLC to conduct an independent review of AEPSC's cost allocation  
20 processes, the necessity of services and the overall reasonableness of AEPSC billings  
21 to SWEPCO. This review includes trend analyses and benchmarking against other  
22 utility service companies, analyses of whether AEPSC services are duplicated at the

1 operating company level, and a review of the cost allocation process used by AEPSC.  
2 An independent third party review of this type is one of the guiding principles set out  
3 in the transmission and distribution utility filing package as a means of meeting the  
4 burden of proof regarding affiliate costs. Patrick J. Baryenbruch has filed testimony  
5 in this case providing that overview of AEPSC and a review of SWEPCO's AEPSC  
6 costs.

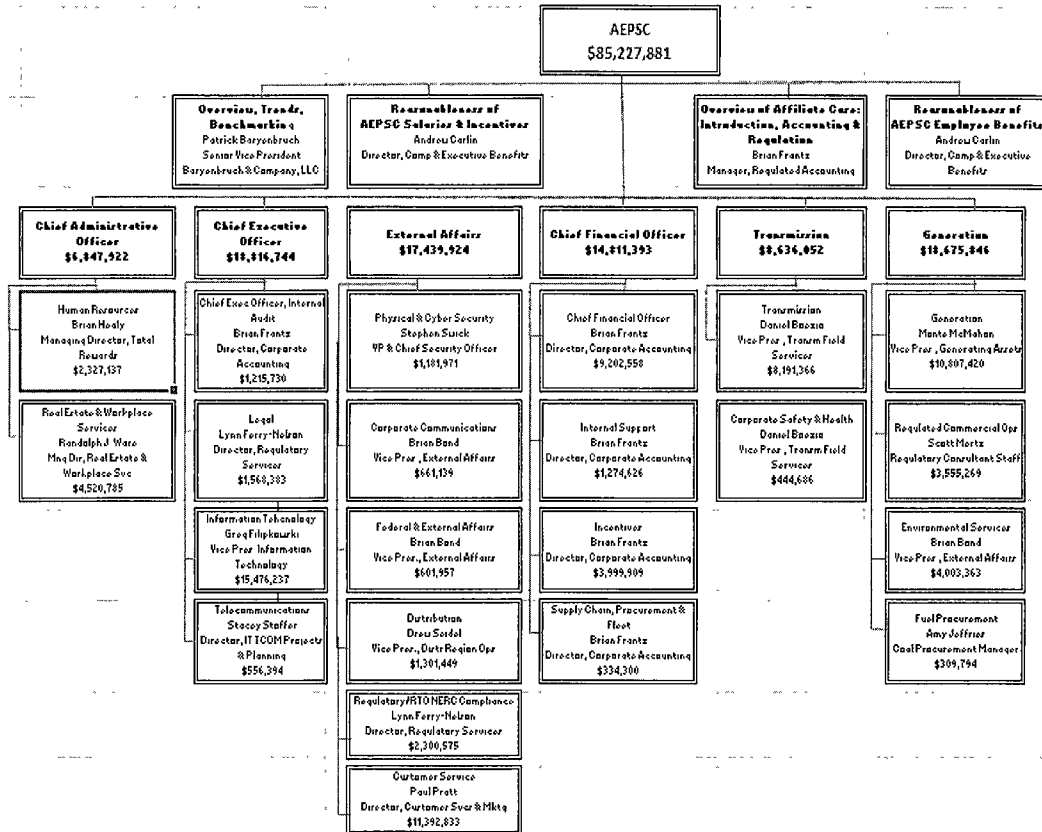
7 Q. PLEASE SUMMARIZE THE WITNESSES PROVIDING AFFILIATE  
8 TESTIMONY SUPPORTING AEPSC COSTS IN THIS RATE CASE.

9 A. Table 2 below depicts the Company's affiliate witnesses for AEPSC and the classes  
10 of service they support:

1

Table 2

AEPSC Costs billed to SWEPCo  
by Class of Service, by Witness



Source: EXHIBIT BJF-1

2 SWEPCO is presenting sixteen witnesses who address the twenty-two classes  
3 of affiliate service. Three of those witnesses, shown in the top boxes of the chart  
4 above, testify either to overall reasonableness and necessity of affiliate costs (myself  
5 and Mr. Baryenbruch) or to the reasonableness and necessity of specific major  
6 components of all affiliate costs such as payroll and benefits (Andrew R. Carlin).

7 The other thirteen affiliate witnesses and I each address the class of service for  
8 which he or she is responsible for or has knowledge. In particular, the witnesses

1 discuss the nature and necessity of the affiliate services provided to SWEPCO and the  
2 reasonableness of the cost of those services.

3 Each witness also presents, as available and meaningful, cost trends, budget  
4 comparisons, staffing trends, benchmarks, and other types of evidence suggested by  
5 the “Guiding Principles” in the RFP, for proof of the reasonableness of SWEPCO’s  
6 affiliate costs.

7 I also present testimony supporting the allocation factors utilized by AEPSC to  
8 ensure that SWEPCO pays no higher rate than any other AEP company for the  
9 services it receives from AEPSC.

10 C. Roadmap of the Affiliate Case

11 Q. HAVE YOU PROVIDED A “ROADMAP” FOR A REVIEW OF SWEPCO’S  
12 AFFILIATE CASE, INCLUDING SCHEDULES AND OTHER DOCUMENTS  
13 FILED IN THIS CASE?

14 A. Yes. We have been meticulous in structuring the entire affiliate-related case around  
15 the classes of service for which we are requesting approval. To that end, this  
16 testimony provides a master cross-reference to source information related to each  
17 class of affiliate cost presented in the Company’s case. This cross-reference is  
18 provided as EXHIBIT BJF-16.

19 Q. PLEASE DESCRIBE EXHIBIT BJF-16.

20 A. EXHIBIT BJF-16 shows where one can locate and review cost detail and evidence  
21 supporting total AEPSC costs, the costs of affiliates other than AEPSC, and each of  
22 the twenty-two AEPSC classes of service presented by the Company. This exhibit

1 references the affiliate witness testimonies, the Exhibits to my testimony, and the  
2 Workpapers (W/P) I provide which support the reasonableness and necessity of  
3 affiliate services and costs, including compliance with the Commission's "no higher  
4 than" standard.

5 Q. PLEASE PROVIDE AN EXAMPLE OF HOW THIS EXHIBIT CAN BE USED TO  
6 REVIEW THE AFFILIATE COSTS INCLUDED IN THIS CASE.

7 A. To explain how to use EXHIBIT BJF-16, I'll use the Customer Service class of  
8 service on page 4 of the Exhibit as an example.

9 Page 4 relates to the Customer Service class and establishes that the Company  
10 witness supporting the class is Paul Pratt. The amount included in the Company's  
11 request is shown, less the total pro-forma adjustments made for that class, resulting in  
12 the net requested amount of \$11,392,833.

13 EXHIBIT BJF-16 points out that the reasonableness and necessity of the costs  
14 and services in this class are discussed in the testimony of Mr. Pratt. In his testimony,  
15 Mr. Pratt provides an overview of SWEPCO's Customer Service organization and  
16 how AEPSC supports that organization. He provides quality of service information,  
17 cost trends, and performance to budget by department. He also provides  
18 benchmarking comparing SWEPCO's customer service costs to those of other service  
19 providers. I discuss the allocation factors used to bill the AEPSC Customer Service  
20 costs to SWEPCO, and why those allocation factors reflect the most representative  
21 cost drivers for the services provided.



1           The next section on page 4 of EXHIBIT BJF-16 provides references to the  
2           workpapers and schedules that contain the supporting information for the Customer  
3           Service class. This section allows the reviewer to examine the amounts billed by  
4           AEPSC in the Customer Service class by:

- 5           • Allocation factor used to bill the service;
- 6           • Benefiting location billed for the service;
- 7           • Activities performed by this class;
- 8           • Departments within the class;
- 9           • Components of the amount, such as labor, outside services, etc.;
- 10          • Category of service within the class, as provided in the witness' testimony;
- 11          • FERC account charged, with pro-forma adjustments; and
- 12          • A listing of the invoices and other items the witness removed from the  
13          request for the class.

14   Q.   PLEASE DESCRIBE HOW THE WORKPAPERS AND SCHEDULES  
15          REFERENCED ON THIS EXHIBIT ARE ORGANIZED.

16   A.   The first workpaper referenced on the Customer Service roadmap is W/P Frantz-2B,  
17          with a page and beginning line reference. This workpaper provides, for each class of  
18          service, a summary of the amount billed using each AEPSC allocation factor (the  
19          usage of which is discussed later in this testimony). Using this workpaper, the  
20          reviewer can see the specific allocation factors used to allocate the Customer Service  
21          class to SWEPCO. The reasonableness of the application of these allocation factors  
22          is then discussed later in my testimony.

23               Each of the workpapers or schedules listed in the roadmap provides the  
24          detailed information of each of the twenty-two classes of service.

1 Q. PLEASE DISCUSS THE FINAL SECTION OF THE CUSTOMER SERVICES  
2 PAGE OF THE ROADMAP, SHOWING THE OTHER TESTIMONY THAT  
3 SUPPORTS ELEMENTS OF THE CLASS OF SERVICE.

4 A. The final section of the Customer Service page of the roadmap provides a listing of  
5 the testimony provided by other witnesses supporting the Customer Service class.  
6 This testimony includes support of the overall reasonableness and necessity of  
7 specific components of each affiliate class, such as labor, and how the allocation of  
8 those costs meets the “no higher than” standard.

9 Q. DID YOU PROVIDE THE AEPSC BILLING INFORMATION FOR THE TEST  
10 YEAR TO THE WITNESSES LISTED IN EXHIBIT BJF-15?

11 A. Yes. I compiled the AEPSC billing information for SWEPCO costs for the test year.  
12 I made a number of pro-forma adjustments that are described below in Section I.D. of  
13 my testimony. The amounts billed to SWEPCO by class of service, and the  
14 adjustments to each class, can be seen on EXHIBIT BJF-1.

15 D. Description of Affiliate Schedules and Pro-Forma Adjustments

16 Q. PLEASE DESCRIBE THE AFFILIATE SCHEDULES IN THE FILING PACKAGE  
17 AND HOW EACH RELATES TO AFFILIATE COSTS INCLUDED IN SWEPCO’S  
18 PROPOSED REVENUE REQUIREMENT.

19 A. Schedules G-6, G-6.1 and G-6.2 of the Filing Package summarize affiliate expenses  
20 requested in the cost of service. Schedule G-6 summarizes the detail provided on  
21 Schedule G-6.1 (Test Year Expense by Affiliate) and Schedule G-6.2 (Adjustments to  
22 Test Year Expense by Affiliate). Schedule G-6.1 provides a summary of the test year

1 affiliate costs by FERC account, affiliate, and class of service. Schedule G-6.2  
2 provides a summary of adjustments to test year affiliate expenses by FERC account,  
3 affiliate, and reason for the adjustment. In addition, I have included Exhibits BJF-1  
4 through EXHIBIT BJF-14 in support of affiliate costs. A description of each of these  
5 exhibits is detailed on my EXHIBIT BJF-17.

6 Q. PLEASE DESCRIBE THE PRO-FORMA ADJUSTMENTS YOU HAVE MADE  
7 TO SWEPCO'S TEST YEAR AFFILIATE COSTS.

8 A. I have made twelve pro-forma adjustments which result in a net decrease to  
9 SWEPCO's test year affiliate costs by the amount of \$7,549,806. Those adjustments  
10 are to:

- 11 1. Remove invoices or line-item charges as requested by supporting affiliate  
12 witnesses, through their review of individual charges to SWEPCO - decrease  
13 of \$1,333,706;
- 14 2. Normalize the amount of annual incentive compensation paid to employees to  
15 target level, excluding financial measures. SWEPCO witness Andrew R.  
16 Carlin discusses the Company's annual incentive compensation program –  
17 decrease of \$5,487,878;
- 18 3. Normalize the amount of long-term incentive compensation paid to employees  
19 to target level, excluding financial measures. SWEPCO witness Carlin  
20 discusses the Company's long-term incentive compensation program –  
21 decrease of \$2,298,741;
- 22 4. Remove corporate aviation charges – decrease of \$1,411,730;
- 23 5. Remove charges related to regulatory filings recoverable through other rate-  
24 making mechanisms – decrease of \$1,567,823;
- 25 6. Adjust the test year benefit plan costs for pension and other post-employment  
26 benefits (Statement of Financial Accounting Standards (SFAS) 106 and SFAS  
27 112) to a 2020 level, per current actuarial estimates – increase of \$731,739;
- 28 7. Adjust payroll to a test year-end level through a recalculation of test year-end  
29 headcount and include a merit increase – increase of \$3,804,876;
- 30 8. Reflect SWEPCO's portion of AEPSC donations for which the Company is  
31 requesting recovery (subject to Commission rule limitation). SWEPCO

1 witness Brian Bond further discusses the requested AEPSC donations –  
2 increase of \$191,814;  
3 9. Remove any additional legislative advocacy expense associated with Edison  
4 Electric Institute dues that were not charged to “below the line” accounts –  
5 decrease of \$49;  
6 10. Normalize the test year impact of the AEPSC Umbrella Trust, which primarily  
7 has assets related to the cash surrender value of insurance policies, to reflect a  
8 five-year trend of the change in the value of these policies – increase of  
9 \$368,465;  
10 11. Remove Supplemental Executive Retirement Plan (SERP) charges – decrease  
11 of \$439,269; and  
12 12. Adjust the AEPSC internal support “loading” charge to reflect the net decrease  
13 in requested costs per the pro-forma adjustments above. AEPSC internal  
14 support is discussed further in Section IV.C. of my testimony – decrease of  
15 \$107,504.  
16 Each of these adjustments, with the calculation and description of the adjustment, is  
17 contained in EXHIBIT BJF-18 and is summarized by FERC Account on EXHIBIT  
18 BJF-2.  
19

## 20 II. MANAGEMENT AND REGULATORY OVERSIGHT OF AEPSC

### 21 A. Organization of AEPSC

22 Q. WHAT IS AEPSC?

23 A. AEPSC is a wholly-owned subsidiary of AEP and is the centralized service company  
24 for the AEP System. AEPSC provides services primarily to AEP’s utility companies  
25 (utility affiliates), including SWEPCO, under a Service Agreement between AEPSC  
26 and SWEPCO dated June 15, 2000. AEPSC performs, at cost, various professional  
27 support services for SWEPCO and the other AEP affiliates. I and the other affiliate  
28 witnesses testifying in this case describe in detail the various support services that

1 AEPSC performed for SWEPCO during the test year. Of the approximately 17,500  
2 employees of the AEP system, approximately 6,400 work for AEPSC.

3 Q. WHAT IS THE PRIMARY MISSION OF AEPSC?

4 A. AEPSC was established first and foremost to provide services to the utility affiliates.  
5 The utility affiliates are the primary subsidiaries of AEP. Because there are similar  
6 utility affiliates that all require the same or similar services, these companies'  
7 operations present the greatest opportunity to achieve economies of scale through  
8 provision of centralized AEPSC services. In addition to the utility affiliates, AEPSC  
9 provides service to several regulated transmission-only subsidiaries (Transcos) and  
10 AEP's transmission joint ventures, as well as to AEP's non-utility subsidiaries.

11 Q. WHAT IS THE NATURE AND EXTENT OF AEPSC'S SERVICES FOR AEP  
12 NON-UTILITY SUBSIDIARIES?

13 A. Of the approximately \$74 billion of assets owned by AEP, approximately 90 percent  
14 are regulated utility affiliate assets. AEP's primary non-utility companies are the AEP  
15 Generation and Marketing organization consisting of competitive generating assets, a  
16 wholesale energy trading and marketing business and a retail supply and energy  
17 management business. The non-utility companies are charged for specific services  
18 provided to them by AEPSC, and they are included in the corporate allocation factors  
19 for items such as payroll, benefits, accounting, auditing, and other corporate  
20 management allocations, where appropriate. AEPSC also bills the parent corporation  
21 for services provided to it such as shareholder support and strategic planning. AEPSC  
22 billings to all affiliates during the test year can be reviewed using EXHIBIT BJF-12.

1 Q. PLEASE DESCRIBE HOW AEPSC IS ORGANIZED.

2 A. AEPSC is functionally organized into the following areas of services: 1) External  
3 Affairs, which includes distribution, customer operations, corporate communications,  
4 and regulatory services; 2) Chief Administrative Officer, which includes real estate  
5 and workplace services and corporate human resources; 3) Generation, which  
6 encompasses regulated generating assets, engineering services, regulated commercial  
7 operations, project and construction services, business services, and environmental  
8 services; 4) Transmission, which includes field services, business operations and  
9 controls, and grid development; 5) Chief Financial Officer, which includes corporate  
10 accounting, corporate planning and budgeting, treasury, finance, investor relations,  
11 risk and strategic initiatives, supply chain, procurement and fleet services; 6) Energy  
12 Supply; 7) Utilities; and 8) Chief Executive Officer, which includes the AEP  
13 Chairman and his staff, audit services, information technology, telecommunications,  
14 and legal services.

15 Q. DO ALL OF THESE AREAS PROVIDE SERVICES TO SWEPCO?

16 A. All of these areas provide services to SWEPCO, with the exception of Energy Supply,  
17 whose primary responsibility is to serve the AEP Generation and Marketing segment  
18 subsidiaries.

19 Q. WHERE ARE THE AEPSC EMPLOYEES WHO PERFORM SERVICES FOR  
20 SWEPCO LOCATED?

21 A. The primary service company centers are located in Columbus, Ohio; Canton, Ohio;  
22 and Tulsa, Oklahoma. These three locations employ approximately half of the

1 AEPSC employees. AEPSC employees are also located throughout the areas of the  
2 AEP utility companies. In SWEPCO's case, AEPSC employees provide services  
3 from offices in Dallas, Austin, and Corpus Christi, Texas. Since many of the services  
4 that are provided are centralized to reduce the number of personnel needed and to  
5 reduce the costs to provide those services, activities may be provided from any of  
6 several locations. For example, AEPSC has six customer service call centers where  
7 customer calls for all AEP utilities are answered. Any of these centers back up other  
8 call centers when call volume is high, service customer calls efficiently and reduce the  
9 number of customer service representatives necessary to support any one company.

10 Q. ARE THERE ADVANTAGES THAT RESULT FROM SWEPCO'S RECEIPT OF  
11 CENTRALIZED SUPPORT SERVICES?

12 A. Yes. AEPSC has evolved over the years to provide services in areas where  
13 economies can be produced through a common knowledge and provision of services  
14 using shared systems, such as the customer accounting and billing, property, payroll,  
15 accounting and other systems. It also achieves economies through standardized  
16 processes being performed by one system-wide department, such as the payment of  
17 invoices or the provision of engineering studies for new facilities. Using the service  
18 company to provide these services allows the operating companies to concentrate  
19 their efforts on serving the immediate needs of their customers, while common  
20 processes can be performed in a centralized manner to promote efficiency and cost  
21 savings.

1 B. Management Oversight and Controls

2 Q. WHAT MANAGEMENT OVERSIGHT AND CONTROLS EXIST TO ENSURE  
3 THE COSTS ARE APPROPRIATELY BILLED TO THE PROPER AFFILIATE?

4 A. AEPSC employs many levels of oversight to ensure that its costs are billed accurately.

5 The management oversight and controls can be divided into three main categories:

6 1) accounting system controls, which ensure that the accounting systems are operating

7 correctly and that the mechanical processing is accurate; 2) management oversight,

8 including review of departmental charges to budgets, variance explanations, and

9 review of the monthly AEPSC bill; and 3) audit and reporting oversight, which

10 incorporates the internal and external audits performed on AEPSC as well as state and

11 federal regulatory reporting requirements. Each of these areas is discussed in detail

12 on EXHIBIT BJF-10.

13 Q. PLEASE REVIEW THE ACCOUNTING SYSTEM CONTROLS.

14 A. The accounting system controls include the following:

15 • Transaction validation where the accounting information is validated as to its  
16 accuracy at the point of entry;

17 • Mechanical reviews, which test the mechanics of the system to ensure the system  
18 is operating as expected; and

19 • Variance review, which is performed to understand the reasons for increases or  
20 decreases in total AEPSC costs for the month.

21 Q. PLEASE DISCUSS THE MANAGEMENT OVERSIGHT OF AEPSC CHARGES.

22 A. Management oversight of the AEPSC bill consists primarily of:

23 • Internal AEPSC budget and actual cost reviews; and

24 • Monthly review of the AEPSC bill by affiliate companies. A copy of the March  
25 2020 AEPSC billing rendered to SWEPCO is provided in EXHIBIT BJF-19. In



1           addition, the monthly AEPSC review document provided to SWEPCO and other  
2           affiliate management is provided as EXHIBIT BJF-20.

3   Q.   WHO IS RESPONSIBLE FOR THE EXTERNAL OVERSIGHT AND  
4       REGULATION OF AEPSC'S OPERATIONS AND BILLINGS?

5   A.   FERC is responsible for the oversight and regulation of AEPSC under the Public  
6       Utility Holding Company Act of 2005. The Commission, in proceedings such as  
7       these, also reviews charges from AEPSC to SWEPCO. In addition, the state  
8       commissions in AEP's other service territories review charges from AEPSC in similar  
9       proceedings or through various filing requirements.

10  Q.   PLEASE DISCUSS THE EXTERNAL AUDIT AND REPORTING OVERSIGHT  
11       OF THE AEPSC BILLING PROCESS.

12  A.   AEPSC is subject to numerous audit and reporting requirements, both as a member of  
13       the AEP Corporation for financial reporting, and as a requirement of federal and state  
14       jurisdictions. These requirements include:

- 15       • Annual AEP independent audit by PricewaterhouseCoopers LLP;
- 16       • Audit required under the 16 Tex. Admin. Code (TAC) § 25.272, "Code of Conduct  
17       for Electric Utilities and Their Affiliates," filed every three years, showing  
18       compliance with the Texas affiliate code of conduct;
- 19       • Annual "Report of Affiliate Activities" filed with the Commission;
- 20       • Annual Affiliate Activities report filed with the Virginia State Corporation  
21       Commission;
- 22       • FERC Form 60 which is the annual report of AEPSC financials and allocations;
- 23       • Maintenance of an AEPSC Cost Allocation Manual, which documents AEPSC's  
24       cost allocation methodologies and accounting procedures and which is required by  
25       the states of Kentucky, Ohio, Oklahoma and Arkansas; and
- 26       • Periodic audits of AEPSC accounting and billing procedures conducted by FERC  
27       staff.

1 C. Standards Governing Recovery of Affiliate Costs

2 Q. ARE AFFILIATE EXPENSES ADDRESSED IN THE TEXAS PURA?

3 A. Yes, affiliate expenses are addressed by PURA § 36.058. Section 36.058 allows an  
4 electric utility to include in its revenue requirement payments to affiliates that meet  
5 the requirements of § 36.058(b). Section 36.058(b), in turn, directs the Commission  
6 to allow recovery of affiliate payments “only to the extent that the regulatory authority  
7 finds the payment is reasonable and necessary for each item or class of items...” In  
8 addition, § 36.058(c) requires that the Commission find that “the price to the electric  
9 utility [for the affiliate service] is not higher than the prices charged by the supplying  
10 affiliate for the same item or class of items” to other affiliates or to non-affiliated  
11 persons. Because the billings of AEPSC and other AEP utility companies to  
12 SWEPCO are affiliate charges, the requirements of § 36.058 apply to those billings.  
13 Finally, sub-section 36.058(f) provides:

- 14 (f) If the regulatory authority finds that an affiliate expense for the test  
15 period is unreasonable, the regulatory authority shall:  
16 (1) determine the reasonable level of the expense; and  
17 (2) include that expense in determining the electric utility’s  
18 service.

19 Under this provision, if the Commission finds that a utility applicant has not met its  
20 burden of proof concerning the reasonableness of an affiliate class or item, instead of  
21 disallowing the entirety of the amount in question, the Commission must determine  
22 the reasonable level of cost and include that reasonable level in the utility’s cost of  
23 service.

1 Q. DOES THE PUBLIC UTILITY COMMISSION OF TEXAS ALSO HAVE RULES  
2 PERTINENT TO THE REVIEW OF AFFILIATE TRANSACTIONS?

3 A. Yes. 16 TAC § 25.272 discusses the code of conduct for electric utilities and their  
4 affiliates. Specifically, § 25.272(e)(1) states that a utility and its affiliates must fully  
5 allocate costs for shared services:

6 ...In accordance with PURA and the commission's rules, a  
7 utility and its affiliates shall fully allocate costs for any shared  
8 services, including corporate support services, offices,  
9 employees, property, equipment, computer systems, information  
10 systems, and any other shared assets, services, or products.

11 Q. HOW ARE CORPORATE SUPPORT SERVICES DEFINED IN THE  
12 SUBSTANTIVE RULES?

13 A. 16 TAC § 25.272(c)(4) defines corporate support services as those "joint corporate  
14 oversight, governance, support systems and personnel," "shared by a utility, its parent  
15 holding company, or a separate affiliate created to perform corporate support  
16 services...." AEPSC is such an affiliate. This section of the rule further provides  
17 examples of the types of support services that may be shared, including accounting,  
18 human resources, procurement, information technology, regulatory services, legal  
19 services, environmental services, research and development, internal audit,  
20 community relations, and corporate services, among others. The services provided to  
21 SWEPCO by AEPSC are of the same type referenced in the Commission's rule.

22 Q. DO THE AFFILIATE COSTS INCLUDED IN SWEPCO'S REVENUE  
23 REQUIREMENT COMPLY WITH APPLICABLE STANDARDS IN TEXAS  
24 STATUTES AND RULES?

1 A. Yes, they do. I and other witnesses will discuss how the costs meet the tests for being  
2 reasonable and necessary, and that these costs are no higher than prices charged by the  
3 affiliate to others.

4 D. The Public Utility Holding Company Act of 2005

5 Q. PLEASE DISCUSS FERC REGULATION OF SERVICE COMPANIES, SUCH AS  
6 AEPSC.

7 A. With FERC Order No. 667, issued December 9, 2005, the FERC amended its  
8 regulations to repeal the Public Utility Holding Company Act of 1935 and adopted  
9 rules to implement the Public Utility Holding Company Act of 2005. The FERC also  
10 continues to exercise its authority over affiliate transactions under the Federal Power  
11 Act. These laws give the FERC authority to examine the propriety of AEPSC charges  
12 and allocation factors

13 Q. DOES THE FERC REVIEW AEPSC BILLING PROCEDURES AND  
14 ALLOCATION METHODOLOGIES?

15 A. Yes. On an annual basis, the FERC requires the filing of the FERC Form No. 60,  
16 "Annual Report of Centralized Service Companies." In addition, the FERC just  
17 completed an audit of AEP affiliate transactions in 2019. The focus of this audit was  
18 AEPSC billing and allocation processes, as well as compliance with the FERC chart  
19 of accounts, FERC Form 60 requirements, and record retention requirements.

1                   III. THE AEPSC ACCOUNTING AND BILLING PROCESS

2                   A. Overview of AEPSC Accounting System

3       Q.       HOW IS THE ACCOUNTING FOR AEPSC CHARGES PERFORMED?

4       A.       AEPSC uses a work order accounting system to identify and bill each service  
5               performed for affiliate companies. For each service performed by AEPSC, three  
6               questions are key:

- 7                   1. WHO should be billed for the service?  
8                   2. HOW should the service be billed?  
9                   3. WHAT service was provided?

10       AEPSC's accounting and billing systems were developed to bill affiliates based on  
11       these basic elements. The primary accounting codes that determine how AEPSC  
12       costs are billed, and which I'll discuss in detail below, are:

- 13                   • Benefiting Location (tells *who* to bill)  
14                   • Allocation Factor (tells *how* to bill)  
15                   • Work Order/Activity Code (tells *what* service was provided)

16                   1. Benefiting Location (Who To Bill)

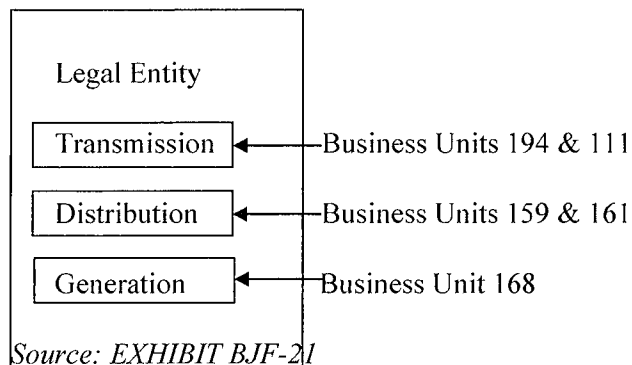
17       Q.       PLEASE DESCRIBE HOW THE AEP COMPANIES ARE STRUCTURED FOR  
18               REPORTING AND AEPSC BILLING.

19       A.       An understanding of how the AEP companies are structured for internal and external  
20               reporting is an important basic element in understanding how AEPSC costs are billed.

21               Each utility company is subdivided into multiple "Business Units." For most  
22               utilities, these Business Units are Transmission, Distribution and Generation, such as  
23               SWEPCO, as seen below:

1  
2

*Table 3*  
**SWEPCO – Business Units**



3           SWEPCO is a legal entity or corporation, owning transmission, distribution  
4 and generation assets. SWEPCO prepares financial statements on the legal entity  
5 basis—all Business Units combined. However, the records for SWEPCO are  
6 separated into five Business Units as shown in the illustration above. This  
7 “unbundling” was done by all AEP utility subsidiaries in anticipation of the  
8 restructuring of the utility industry. AEPSC bills its affiliates by individual Business  
9 Unit.

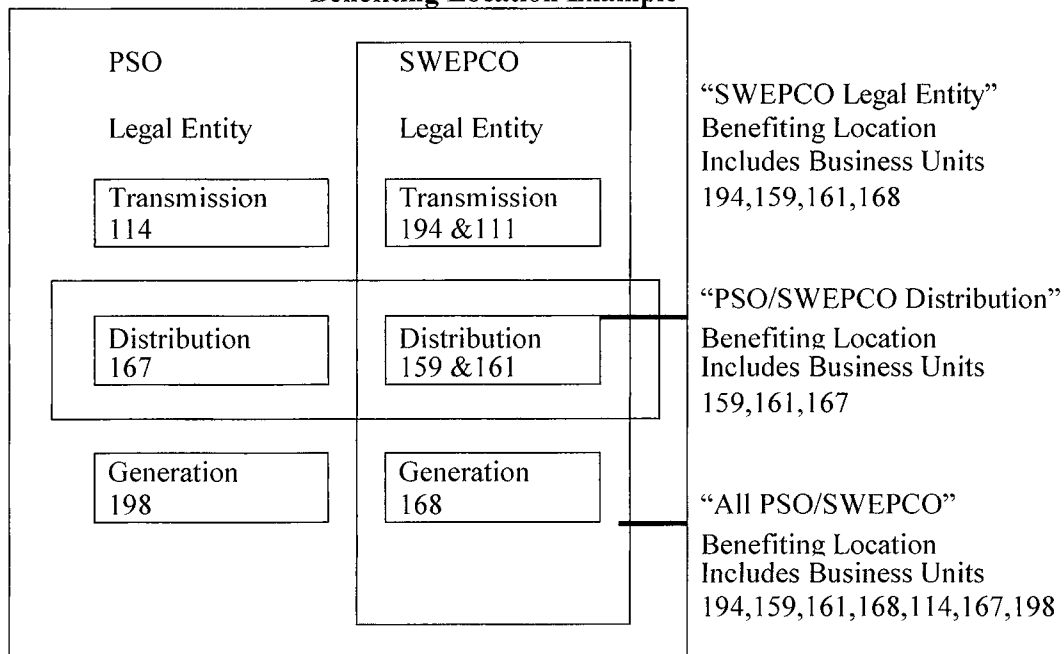
10           As part of this unbundling process, separate Business Units were created to  
11 separate SWEPCO’s transmission and distribution (T&D) functions in Texas, in order  
12 to segregate SWEPCO’s Texas T&D activities from SWEPCO’s T&D activities in  
13 Arkansas and Louisiana. This segregation was in anticipation of competition in the  
14 state of Texas. Since SWEPCO has not operationally separated any of its functions,  
15 the separate Business Units are not used for any type of financial reporting, regulatory  
16 matters, or jurisdictional allocation purposes. For all reporting purposes, the Business  
17 Units are consolidated to form SWEPCO financial statements.

1 Q. PLEASE EXPLAIN HOW THE BUSINESS UNITS COMBINE TO FORM  
2 BENEFITING LOCATIONS.

3 A. A Benefiting Location is one or a combination of Business Units. The Benefiting  
4 Location can be one Business Unit, such as SWEPCO Transmission only, or it can be  
5 a combination of Business Units, such as the five SWEPCO Business Units in Table  
6 3 above. Benefiting Locations are often combinations of “similar” or “regional”  
7 Business Units across multiple companies, such as all Distribution Business Units, all  
8 Texas Business Units, all Southwest Power Pool (SPP) or Electric Reliability Council  
9 of Texas (ERCOT) Transmission Business Units, etc. Below is an example of how  
10 various Business Units comprise a Benefiting Location.

11 *Table 4*

12 **Benefiting Location Example**



1 As is seen above, Public Service Company of Oklahoma (PSO) and SWEPCO can  
2 combine to form numerous Benefiting Locations. By combining Business Units 194,  
3 159, 161 and 168, AEPSC creates a Benefiting Location to bill all SWEPCO Business  
4 Units, or the entire SWEPCO legal entity. A combination of Business Units 167, 159  
5 and 161 creates a Benefiting Location to bill PSO and SWEPCO Distribution  
6 Business Units. Combining all Business Units above would create a Benefiting  
7 Location that billed all Business Units in the PSO/SWEPCO region. When the cost  
8 of a particular service should be billed to more than one Business Unit, AEPSC uses  
9 these combinations of Business Units, called a *Benefiting Location*, to bill those costs.

10 Q. HOW ARE THE BENEFITING LOCATIONS CHOSEN TO BILL CHARGES TO  
11 THE APPROPRIATE COMPANIES?

12 A. An employee chooses the Benefiting Location through his or her choice of the  
13 appropriate work order for the work performed. Work orders have a pre-established  
14 Benefiting Location and are discussed in more detail later in this section.

15 Q. PLEASE DESCRIBE THE BENEFITING LOCATIONS THAT INCLUDED  
16 SWEPCO BUSINESS UNITS DURING THE TEST YEAR.

17 A. AEPSC used 99 different Benefiting Locations to bill services during the test year that  
18 included SWEPCO business units. These Benefiting Locations, including a  
19 description of the Business Units included in each one, are attached to this testimony  
20 as EXHIBIT BJF-21. Benefiting Locations used in connection with billings to  
21 SWEPCO during the test year included, for example, all Business Units within  
22 SWEPCO, all western generation companies, all distribution companies within AEP,



1 and all transmission companies within AEP. Of the charges SWEPCO received from  
2 AEPSC during the test year, 24% of those charges were made to SWEPCO Business  
3 Units only, or in effect, direct billed. No other companies were included in the  
4 allocation of those costs.

5 Q. IF A CHARGE IS ALLOCATED USING A BENEFITING LOCATION THAT  
6 INCLUDES MORE THAN ONE SWEPCO BUSINESS UNIT, HOW CAN THAT  
7 BE CONSIDERED A "DIRECT" CHARGE?

8 A. Functional separation within a legal entity such as SWEPCO does not equate to an  
9 "allocation" to that legal entity when each functionally separate Business Unit is  
10 billed. It is necessary to combine the Business Units within one company to  
11 determine the amount of charges that are directly billed versus allocated.

12 2. Allocation Factor (How To Bill)

13 Q. YOU STATED EARLIER THAT THE "ALLOCATION FACTOR" PROVIDES  
14 THE "HOW" OF THE BILLING PROCESS. PLEASE EXPLAIN.

15 A. Allocation factors are mathematical formulas that have been developed to provide fair  
16 and reasonable methods to allocate joint costs. Each charge made by AEPSC for a  
17 service provided has the Benefiting Location that determines *WHO* to bill, as I  
18 discussed earlier, and also has an allocation factor attached to it which determines  
19 *HOW* the charge should be divided among the Business Units receiving the service.

20 Q. WHAT ALLOCATION FACTORS ARE USED BY AEPSC TO BILL  
21 AFFILIATES?

1 A. EXHIBIT BJF-11 shows the allocation factors that are available to allocate costs to  
2 affiliates. AEPSC has eighty FERC-accepted allocation factors. Only thirty-five of  
3 the allocation factors were used on the costs billed to SWEPCO during the test year  
4 since some of the allocation factors do not apply to SWEPCO (such as hydro plant  
5 megawatt generating capability), and we have discontinued using others. A chart  
6 showing the amounts billed by allocation factor is presented later in this section, as  
7 Table 5.

8 Q. GENERALLY DESCRIBE THE ALLOCATION FACTORS.

9 A. The allocation factors used to bill SWEPCO for services performed by AEPSC are  
10 based upon statistics such as number of customers, number of employees, total assets,  
11 number of transmission pole miles and other criteria as shown on EXHIBIT BJF-11.  
12 The data upon which these factors are based is updated monthly, quarterly, semi-  
13 annually or annually, depending on the particular basis. When a cost is allocated, the  
14 allocation factor is applied to the business units that make up the benefiting location  
15 that was chosen for the billing. Thus, only those business units who benefit from the  
16 service are allocated their portion of the cost.

17 Q. WHAT TYPES OF CONSIDERATIONS GO INTO CHOOSING AN  
18 ALLOCATION FACTOR FOR A PARTICULAR WORK ORDER OR ACTIVITY?

19 A. A volume-driven factor is used in all cases where the cost driver is volume based and  
20 the data is available. For example, in allocating costs for processing accounts  
21 payable, each affiliate receiving the service might be billed based on its relative  
22 percentage of the number of vendor invoice payments processed by AEPSC; for

1 mailing customer bills, each affiliate's relative percentage of the total mailings might  
2 be used.

3 If a work order does not have a direct volume-based cost driver, the most  
4 representative factor for the service provided is used. For example, for administering  
5 employee benefit plans, number of employees might be used; for managing and  
6 dispatching the transmission system, number of transmission pole miles might be  
7 used; and for financial reporting, total assets might be used. The allocation factors are  
8 designed to ensure that the charges are in proportion to the benefits received by the  
9 benefiting companies.

10 Q. WHAT SHOULD BE THE OBJECTIVE OF AN ALLOCATION METHOD?

11 A. An allocation method should be used which allocates costs on a basis that reasonably  
12 relates the cost to the activity generating the cost. For example, when more activity  
13 generates more cost, an allocation factor that captures that characteristic provides a  
14 reasonable relationship between the dollars allocated and the demand for the service.  
15 The allocation factors should be applied consistently for similar services and should  
16 be fairly stable over time. In my opinion, AEPSC's continued use of the approved  
17 allocation factors accomplishes these objectives.

18 Q. CAN ALL COSTS BE CHARGED DIRECTLY TO EACH COMPANY, INSTEAD  
19 OF ALLOCATED THROUGH A FACTOR?

20 A. No. While costs are directly billed to the extent practicable, costs jointly incurred on  
21 behalf of one or more affiliates must be allocated because the product or service  
22 provided is not reducible to discrete, easily divisible parts. For example, if an AEPSC

1 distribution engineer were working on a standard substation design that will be used  
2 by all of the distribution companies in the AEP system, it would not be practical or  
3 possible to identify and direct bill discrete portions of the design to individual  
4 distribution Business Units. As a result, that engineer would bill the cost of that  
5 project to all distribution Business Units using a distribution-related allocation factor.  
6 If the AEPSC engineer prepared a separate drawing for each company in order to  
7 direct bill such services, it would be necessary to duplicate the staffing and resources  
8 used to provide the service for each affiliate using the service, thereby defeating the  
9 very purpose of having the service company.

10 Q. PLEASE SUMMARIZE THE AEPSC BILLINGS TO SWEPCO DURING THE  
11 TEST YEAR BASED ON THE ALLOCATION FACTORS USED.

12 A. Table 5 below shows the billings to SWEPCO by allocation factor, and it indicates in  
13 the two columns whether that billing was: (a) charged to a combination of only  
14 SWEPCO Business Units, such that the charge was in effect a direct bill to SWEPCO;  
15 or (b) if it was allocated to SWEPCO along with other AEP Business Units.

16 The table shows that 24% of the total charges to SWEPCO were billed to only  
17 SWEPCO Business Units.

Table 5  
AEPSC Charges to SWEPCO  
By Allocation Factor and by Benefiting Location

Allocation Factor	(a) Directly Billed to SWEPCO	(b) Allocated to SWEPCO	Total by Allocation Factor	%
05 - Number of CIS Customers Mail		594,618	594,618	0.7%
06 - Number of Commercial Customers		66,052	66,052	0.1%
08 - Number of Electric Retail Cust		5,425,692	5,425,692	6.2%
09 - Number of Employees		4,879,544	4,879,544	5.6%
11 - Number of GL Transactions		1,059,024	1,059,024	1.2%
16 - Number of Phone Center Calls		2,957,059	2,957,059	3.4%
17 - Number of Purchase Orders		314,388	314,388	0.4%
20 - Number of Remittance Items		255,943	255,943	0.3%
26 - Number of Stores Transactions		84,030	84,030	0.1%
27 - Number of Telephones		325,830	325,830	0.4%
28 - Number of Trans Pole Miles		2,013,760	2,013,760	2.3%
31 - Number of Vehicles		71,814	71,814	0.1%
32 - Number of Vendor Invoice Pay		(182,211)	(182,211)	-0.2%
33 - Number of Workstations		2,306,777	2,306,777	2.6%
37 - AEPSC Past 3 Months Total Bill		196,976	196,976	0.2%
39 - 100% to One Company	21,378,104		21,378,104	24.4%
40 - Equal Share Ratio		74,140	74,140	0.1%
44 - Level of Const-Distribution		34,371	34,371	0.0%
46 - Level of Const-Transmission		167,986	167,986	0.2%
46 - MW Generating Capability		11,843,266	11,843,266	13.5%
49 - MWH's Generation		2,139,429	2,139,429	2.4%
51 - Past 3 Mo MMBTU's Burned (Tot)		632,773	632,773	0.7%
52 - Past 3 Mo MMBTU Burned (Coal)		76,026	76,026	0.1%
53 - Past 3 Mo MMBTU (Gas)		17,449	17,449	0.0%
55 - Past 3 MMBTU Burned (Solid)		8,013	8,013	0.0%
57 - Tons of Fuel Acquired		20,923	20,923	0.0%
58 - Total Assets		22,872,802	22,872,802	26.1%
60 - AEPSC Bill less Indir and Int		523,696	523,696	0.6%
61 - Total Fixed Assets		2,359,575	2,359,575	2.7%
63 - Total Gross Utility Plant		1,362,142	1,362,142	1.6%
64 - Member/Peak Load		3,513,153	3,513,153	4.0%
67 - Number of Banking Transactions		101,763	101,763	0.1%
70 - No Nonelectric OAR Invoices		44,173	44,173	0.1%
77 - Power Transactn to All Markets		3,287	3,287	0.0%
<b>Total Included in Cost of Service by Allocation Factor</b>	<b>21,378,104</b>	<b>66,164,263</b>	<b>\$87,542,367</b>	<b>100.0%</b>
	24%	76%	100%	
Pro-formas not applied by Allocation Factor	(2,314,486)		(2,314,486)	
<b>Total Included in Cost of Service</b>	<b>\$19,063,618</b>	<b>\$66,164,263</b>	<b>\$85,227,881</b>	

1 Source: W/P Frantz - 2A

1                                    3. Work Order/Activity Code (What Service to Bill)

2     Q.     WHAT IS A WORK ORDER AND HOW DOES IT RELATE TO THE BILLING  
3             PROCESS?

4     A.     Generally speaking, a work order is an electronic file used as a means to accumulate  
5             like charges into one grouping. The work order is the means to bring the benefiting  
6             location, allocation factor, and purpose for the work into one billable unit.

7     Q.     PLEASE DESCRIBE HOW A WORK ORDER IS ESTABLISHED.

8     A.     A work order can be requested by any employee who wishes to track costs for a  
9             specific project. The employee who requests a work order provides information to  
10            the AEPSC Accounting department concerning the nature of the work to be  
11            performed and the Business Units who will be the beneficiaries of the service. The  
12            request is reviewed and approved by the manager of the requesting employee.

13            Using this information, the AEPSC Accounting Department assigns the  
14            Benefiting Location, which determines who will be billed for the work, as I described  
15            earlier in this testimony, and an allocation factor. The allocation factor is chosen to  
16            reflect the characteristic that most clearly drives the cost of the service—for example,  
17            number of customers or total assets. The majority of the AEPSC work orders receive  
18            final approval from my department. Some work orders are initiated through a field-  
19            based system.

20    Q.     WHAT OTHER INFORMATION IS CAPTURED WITH THE WORK ORDER?

21    A.     Accounting information such as the department which made the charge, an activity  
22            code that describes the type of service provided, the FERC account associated with

1 the charge, a cost component which indicates the category of cost incurred (labor,  
2 etc.), and other codes used for reporting and analysis are captured in the accounting  
3 records. Accounting within each work order is in accordance with the FERC Uniform  
4 System of Accounts. These additional elements are further described in EXHIBIT  
5 BJF-9.

6 Q. YOU MENTION "ACTIVITY CODES." PLEASE EXPLAIN WHAT YOU MEAN  
7 BY THAT.

8 A. Activity codes are used in conjunction with work orders and are another means of  
9 making the accounting selection process for employees more understandable and  
10 dynamic.

11 When an employee makes a charge, they need only select the work order as  
12 described above, and an activity code, to accomplish the billing. The activity code  
13 indicates, for all work orders, the business activity performed. This facilitates cost  
14 analyses. For certain work orders, the activity code is linked to the allocation factor  
15 that will be used to allocate the charges to the affiliates.

16 Employees choose the appropriate activity using a hierarchal listing of  
17 activities which is available on-line to all employees in the company. This hierarchy  
18 allows "drill-down" into the activities that cover each area. For example, a screen-  
19 shot of the activities available for "Managing the Accounting & Finance" processes  
20 shows that nineteen activities are available in these areas:

1  
2

*Table 6*  
**Screen-shot of Activity Dictionary for Accounting and Finance Activities**

ABM Activity

ABM Activity

Active All By Process Group (Active) ... 1 Field as Active

✓ Process Group ▼	Major Process ▼	Business Process	Activity Number	Activity Name
✓ MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Prepare, Approve & Review Budgets	329	Prepare Long Term Financial Plans
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Maintain Corporate Books & Financial Records	333	Develop, Update & Administer Accounting Policies, Procedures & Instructions
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Maintain Corporate Books & Financial Records	334	Maintain General Ledger
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Maintain Corporate Books & Financial Records	335	Administer Lease & Rental Agreements
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Maintain Corporate Books & Financial Records	336	PERF FUEL ACCOUNTING REG COS
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Conduct Financial & Regulatory Reporting	355	Prepare Internal Financial Reports & Studies
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Conduct Financial & Regulatory Reporting	356	PREP/FILE EXT/REG REPORTS REG
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Account for Electric Plant Assets	360	Perform Owned Asset Accounting
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Manage Financial Resources	621	Manage Cash
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Perform Tax Compliance/ Planning & Reporting	656	Tax Compliance - Federal
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Perform Tax Compliance/ Planning & Reporting	657	Coordinate Tax Accounting & Regulatory Support Services
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Perform Tax Compliance/ Planning & Reporting	658	Coordinate Tax Planning & Analysis
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Manage Financial Resources	661	Manage & Participate in Corporate Financing
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Manage Financial Resources	662	Manage Trust & Investments
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Prepare, Approve & Review Budgets	676	Develop, Monitor & Analyze Budgets
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Manage Financial Resources	712	Manage Short Term Funding
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Manage Financial Resources	713	Manage Factoring
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Maintain Corporate Books & Financial Records	974	Provide for General Ledger Journal Expense (Identified Users Only)
MANAGE & SUPPORT THE BUSINESS	Manage Accounting & Finance	Perform Tax Compliance/ Planning & Reporting	655	Tax Compliance - State/Local

3 By accessing this on-line listing, employees can further review the details

4 behind each activity code, to make sure that the activity is appropriate for the service

5 they are providing. Using an activity from Table 6 above, Activity 334 - Maintain

6 General Ledger, an employee can drill-down further to see more details about that

7 activity, as is seen in the screen-shot in Table 7 below:



1  
2

Table 7  
Screen-shot of Activity 334 – Maintain General Ledger

Process Group *	MANAGE & SUPPORT THE BUSINESS
Major Process *	Manage Accounting & Finance
Business Process *	Maintain Corporate Books & Financial Records
Activity	334-Maintain General Ledger
Activity Number *	334
Activity Name *	Maintain General Ledger
Activity Description *	This activity includes reconciling and balancing all ledgers. Includes both labor and systems costs for ledger maintenance.
Major Tasks *	Setup and amortize deferrals and prepayments Record entries to the ledgers Reconcile and balance of ledgers Review completed ledgers for accuracy Prepare and input journal entries Close the financial books Interchange power billings and recording of system pool and purchases power transactions Record Prepaid Insurance Maintain account and work order validation files Prepare annual escheat reports Record OICA activities Maintain material management (other than fuel and leased assets) accounting Prepare file maintenance (Account Master File, FMG, AEPSC Work Order system)
Suggested FERC Accounts *	920-923
ServiceCorp Attribution Basis *	<div><input type="checkbox"/> 100% to AEP Credit <input type="checkbox"/> 58 Total Assets <input type="checkbox"/> Level of Construction - Distribution <input type="checkbox"/> Megawatt Generating Capability <input type="checkbox"/> Megawatt hours Generation <input type="checkbox"/> Number of Banking Transactions <input type="checkbox"/> Number of Commercial Customers <input type="checkbox"/> Number of Electric Retail Customers Excluding 119 &amp; 211 (Texas) <input checked="" type="checkbox"/> Number of GL Transactions</div> <div><input type="checkbox"/> 100% to One Company <input type="checkbox"/> Hydro MW Generating Capability <input type="checkbox"/> Level of Construction - Transmission <input type="checkbox"/> Megawatt Hours Generation <input type="checkbox"/> MMBTU's Burned (All Fuel Types) <input type="checkbox"/> Number of CIS Customer Mailings <input type="checkbox"/> Number of Electric Retail Customers</div>
Allocation Factor	

3 The screen-shot shows that an employee can further access information about major  
4 tasks that are appropriate to charge using the activity, suggested FERC account usage,  
5 and the AEPSC allocation factor that will be used to bill the cost.

6 Q. WHAT TYPES OF QUALITY ASSURANCE PRACTICES ARE EMPLOYED IN  
7 THE INITIATION OF A WORK ORDER?

1 A. When a work order is first requested, both the selection of the benefiting location and  
2 the assignment of the allocation factor are reviewed and approved by a manager with  
3 supervisory responsibility for the work to be performed to ensure that it is properly  
4 assigned. In addition, my department is responsible for approving most AEPSC work  
5 order requests, and we review and approve the benefiting location and allocation  
6 factor prior to the work order being activated by the AEPSC Accounting Department.

7 Q. DO THE SAME AEPSC BILLING PROCESSES THAT APPLY TO EXPENSES  
8 ALSO APPLY TO CAPITAL COSTS BILLED BY AEPSC, WHICH ARE SHOWN  
9 ON EXHIBIT BJF-5?

10 A. Yes, AEPSC uses one billing process, work order system and system of controls, all  
11 described in Section III of this testimony, whether the cost billed is expense or capital.

12 Q. PLEASE DISCUSS THE DATA PROVIDED ON EXHIBIT BJF-5.

13 A. The schedule shows each capital work order billed by AEPSC to SWEPCO and put  
14 into service since June 30, 2016. The schedule shows the function incurring the cost,  
15 the work order title and amount billed, and includes a footnoted description of the  
16 more significant projects included in the period.

17 Q. HOW ARE THE AFFILIATE CAPITAL PROJECTS, SHOWN ON EXHIBIT BJF-  
18 5, BILLED TO SWEPCO?

19 A. The capital projects are billed using the same set of allocation factors that are used for  
20 all other AEPSC work orders, as provided on EXHIBIT BJF-11. When a capital  
21 work order is initiated, an allocation factor and a benefiting location are assigned to  
22 allocate the costs to the companies who benefit from the work. Because capital

1 construction is, by nature, usually associated with a specific company and location,  
2 the majority of the capital work orders are directly billed to the affiliate for whom the  
3 specific work is provided. The overhead and capitalized software work orders,  
4 however, are generally assigned to affiliates through an allocation because they  
5 represent costs for a shared product.

6 The generation, transmission and distribution capital overhead work orders  
7 capture the costs for AEPSC planning, designing, construction management, and  
8 administrative and general overheads, and they are allocated using factors based upon  
9 construction levels. These factors calculate the Company's level of construction, as  
10 compared to the same construction for other affiliates, and allocate the overheads  
11 accordingly. This ensures that the companies who are constructing routine  
12 generation, transmission and distribution projects are charged for the support costs  
13 associated with administering the construction program. These construction  
14 overheads are then allocated by SWEPCO or other AEP affiliates to their construction  
15 projects, in accordance with the FERC Electric Plant Instructions.

16 Capital software charges billed to SWEPCO since June 2016 include costs for  
17 the conversion, implementation, upgrade and replacement of various software  
18 applications. Capital software work orders are billed using various allocation factors,  
19 depending upon the nature of the software. As with the expense allocations, the  
20 allocation factor assigned to each of the capital software work orders is assigned to  
21 most closely match the underlying cost driver, resulting in a reasonable approximation  
22 of the cost to provide that service.

1 Q. HOW DOES THE WORK ORDER SYSTEM ENSURE THAT AEPSC'S  
2 CHARGES TO SWEPCO ARE NO HIGHER THAN THE CHARGES TO OTHER  
3 AFFILIATES FOR THE SAME OR SIMILAR SERVICES, AND THAT THE  
4 CHARGES REASONABLY APPROXIMATE THE ACTUAL COST OF  
5 PROVIDING THE SERVICE TO SWEPCO?

6 A. The AEPSC work order system was designed for the express purpose of meeting the  
7 Securities and Exchange Commission (SEC)/FERC requirements to fairly allocate  
8 common charges among AEP affiliates, and to do so at cost. By using a work order  
9 system, the expenses for specific projects are identified and the work orders are  
10 assigned specific and approved benefiting locations and allocation factors. Common  
11 costs are allocated based on the factor that best matches the charge with the cost  
12 driver related to the service, and that same factor is applied to all companies in  
13 proportion to the benefit they received from the service. In this way, SWEPCO and  
14 every other affiliate included in the benefiting location receiving a service is charged  
15 the same unit price—that is, its appropriate share of the actual cost of the service.  
16 Accordingly, consistent with the requirements of PURA § 36.058(c)(2), the price  
17 charged to SWEPCO for the service (AEPSC's actual cost) is no higher than the price  
18 charged to the other affiliates receiving the service (AEPSC's actual cost).

19 The costs for services benefiting only one company are directly assigned and  
20 are billed 100% to that company by the employee performing the service. Again, the  
21 price for all direct billings—actual cost—is the same for SWEPCO and all other  
22 affiliates receiving direct billings.

B. Charges From Other Affiliates

Q. DID SWEPCO HAVE TRANSACTIONS WITH ANY AEP AFFILIATES OTHER THAN AEPSC?

A. Yes, SWEPCO had transactions with various affiliate companies, in the amount of \$2,406,697, as shown on EXHIBIT BJF-1. The charges from affiliates other than AEPSC are shown in the table below:

*Table 8*  
**SWEPCO Test Year Charges from Affiliates Other Than AEPSC**  
**(in thousands)**

From Affiliate:	Convenience Payments	Service Payments	Grand Total	% Of Total
AEP Texas	\$64	\$680	\$744	31%
Public Service Company of Oklahoma	129	520	649	27%
Ohio Power Company	153	178	331	14%
United Sciences Testing, Inc.	269	0	269	11%
Appalachian Power Company	132	90	222	9%
All other (5) affiliates	10	182	192	8%
Total	\$757	\$1,650	\$2,407	100%

*Source: EXHIBIT BJF-1*

Test year payments by SWEPCO to affiliate companies (other than AEPSC) generally fall into two categories.

The first category is convenience payments, which are pass-through billings from third parties. In those situations, the service to SWEPCO is not provided by an affiliate; however, the affiliate receives an invoice, the cost of which should be borne by more than one company. The affiliate makes a payment to the vendor on behalf of all affected affiliates and bills the other affiliates for their share. For example, an invoice for services rendered related to a distribution matter is addressed to Ohio

1 Power Company but was incurred on behalf of all AEP distribution companies. Ohio  
2 Power received the invoice and made the payment, and then it charged the appropriate  
3 percentage of the invoice to SWEPCO and other affiliates. This payment was a joint  
4 payment, made by Ohio Power as a “convenience” for all parties on the invoice.  
5 SWEPCO would then reimburse Ohio Power for its share of the invoice. Similarly,  
6 there are instances where SWEPCO makes convenience payments on behalf of other  
7 AEP operating companies and bills the other operating companies for their shares of  
8 the bill.

9 The second category is service payments, where the affiliate provides a  
10 service, such as storm assistance. Another example of this type of service billing is  
11 where SWEPCO may have a critical maintenance or repair need, and another  
12 affiliated company has the parts or expertise to perform that task. In those cases,  
13 SWEPCO purchases the parts or services from the affiliate at their cost in order to  
14 expedite the repair. This type of cost is payment for parts or services rendered much  
15 like the billings SWEPCO receives from AEPSC.

16 Q. HOW ARE INTER-COMPANY TRANSACTIONS BILLED BETWEEN THE  
17 VARIOUS OPERATING COMPANIES?

18 A. Transactions are directly billed from one operating company to another, or they are  
19 billed to the appropriate operating company utilizing a similar billing process as that  
20 used by AEPSC. As with AEPSC, expenditures are charged to work orders and are  
21 billed to the business unit benefiting from the service. Costs benefiting only one  
22 business unit are directly billed, while costs that benefit more than business unit are

1 allocated. The result is that SWEPCO is billed by the operating company supplying  
2 the service an amount based on the actual cost to provide that service, with no profit  
3 added.

4  
5 IV. REASONABLENESS AND NECESSITY OF CLASSES OF SERVICE

6 Q. WHAT IS THE PURPOSE OF THIS SECTION OF YOUR TESTIMONY?

7 A. I will describe and address the nature and necessity of the following five classes of  
8 services that were provided to SWEPCO during the test year, and the reasonableness  
9 of the associated costs:

10 a. Chief Financial Officer - \$9,202,558, including:

- 11 • Corporate Accounting
- 12 • Corporate Planning and Budgeting
- 13 • Treasury and Investor Relations
- 14 • Risk and Strategic Initiatives
- 15 • Other Finance Services

16 b. Chief Executive Officer - \$1,215,730, including:

- 17 • Internal Audit
- 18 • Other Chief Executive Officer

19 c. Supply Chain, Procurement & Fleet Operations - \$334,300

20 d. Internal Support - \$1,274,626

21 e. AEPSC Incentives - \$3,999,909

22 A. Chief Financial Officer Class of Service - \$9,202,558

23 Q. WHAT ARE SWEPCO'S ADJUSTED TEST YEAR COSTS PER EXHIBIT BJF-22  
24 FOR CHIEF FINANCIAL OFFICER SERVICES PROVIDED BY AEPSC?

1 A. The Chief Financial Officer (CFO) adjusted test year costs for SWEPCO are  
2 \$9,202,558. These services, shown on EXHIBIT BJF-22 by department within each  
3 class, include the Corporate Accounting, Corporate Planning and Budgeting, Treasury  
4 and Investor Relations, Risk and Strategic Initiatives, and Other Finance Services.

5 Q. HOW DO THESE COSTS BREAK DOWN BY MAJOR AREA?

6 A. The major service categories and the amounts billed to SWEPCO are as follows:

7 *Table 9*  
8 **Chief Financial Officer Class of Service**  
9 **Billed to SWEPCO for the Test Year Ended March 31, 2020**

	<b>Amount in SWEPCO Cost of Service</b>
Corporate Accounting	\$2,560,380
Corporate Planning and Budgeting	1,216,334
Treasury and Investor Relations	1,243,127
Risk and Strategic Initiatives	1,277,720
Other Finance Services	2,904,997
<b>Total Chief Financial Officer</b>	<b>\$9,202,558</b>

*Source: EXHIBIT BJF-22*

10 I will discuss all of these categories of CFO services in more detail later in my  
11 testimony. Before that discussion, however, I will discuss budget and headcount trends  
12 that support the reasonableness of the CFO costs.

13 Q. WHAT ARE THE MAJOR COMPONENTS OF THE CFO CLASS OF SERVICE  
14 COSTS?



1 A. The CFO class of service costs includes the following categories:

2 *Table 10*

3 **Components of Chief Financial Officer Class by Cost Category**

	Labor	Outside Services	Other	Grand Total
Amount	\$ 7,584,719	\$ 1,213,565	\$ 404,274	\$ 9,202,558
% of Total	82%	13%	5%	100%

*Source: W/P Frantz – 7B*

4 The largest single component of the costs in the CFO class is labor, which  
5 makes up approximately 82% of the total CFO class of service. This is because the  
6 CFO group is primarily a service-based organization and has few costs that are not  
7 employee-related. The testimony of Mr. Carlin demonstrates that the labor and benefit  
8 costs incurred by AEPSC are reasonable and market competitive.

9 Q. WHAT IS THE TREND IN HEADCOUNT FOR CHIEF FINANCIAL OFFICER?

10 A. As shown in the table below, headcount for the CFO has decreased over 25% since  
11 2017 due to the outsourcing initiative of certain accounting tasks to a 3<sup>rd</sup> party provider  
12 that was fully implemented in 2019. Even with the decrease in headcount, the CFO has  
13 continued to provide the same level of service to SWEPCO and the other affiliates.

14 *Table 11*

15 **Chief Financial Officer Headcount Trends**

	2017	2018	2019	Test Year End
Headcount	398	347	298	296

*Source: W/P Frantz - 8*

16 Q. PLEASE DESCRIBE HOW THE BUDGETING PROCESS IS USED BY THE  
17 GROUPS IN THE CFO CLASS TO MONITOR COSTS.

1 A. Like all AEPSC departments, the CFO division departments are required to prepare a  
2 budget annually for approval by AEP management, and each month they are required to  
3 explain material variances from the budget. Performance against the pre-established  
4 budgets is an element of all CFO employees' incentive performance payment and is  
5 included in the performance targets for CFO management. This budget versus actual  
6 analysis is reviewed on a "pre-billed" basis, so the following table reflects all of the  
7 CFO budget (excluding incentives) and not just the portion that was billed to SWEPCO,  
8 for the past three years and the test year.

9 *Table 12*  
10 **Chief Financial Officer**  
11 **Budget vs. Actual Trends**  
12 **(in millions)**

	2017	2018	2019	Test Year
Budget O&M Expenditures	\$ 61.7	\$ 55.2	\$ 26.1	\$ 29.1
Actual O&M Expenditures	\$ 41.2	\$ 63.1	\$ 12.1	\$ 41.0
Over (Under) Budget	\$ (20.5)	\$ 7.9	\$ (14.0)	\$ 11.9
Adjustments to Actual O&M Exp:				
Other	\$ 12.2	\$ (15.2)	\$ 5.2	\$ (19.0)
Adjusted Over (Under) Budget	\$ (8.3)	\$ (7.3)	\$ (8.8)	\$ (7.1)

13 The CFO's adjusted actual O&M expenditures for each period have been consistently  
14 lower than budget. The adjustments to actual O&M expense amounts relate to items  
15 that are not included in the budget. As a "back-office" support area, there is continual  
16 pressure to find cost savings and justify spending to assure that the services are  
17 provided at the lowest cost. Additionally, employee vacancies are carefully analyzed  
18 to ensure that all options are reviewed to eliminate the position if possible. The  
19 trends in these O&M costs are discussed in more detail in the subsections below.

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Corporate Accounting Services

Q. PLEASE DESCRIBE THE CORPORATE ACCOUNTING SERVICES PROVIDED TO SWEPCO.

A. As shown in Table 9 above, SWEPCO was billed \$2,560,380 during the test year for corporate accounting services. I have divided the accounting services into four categories that reflect the major departments providing the services to SWEPCO:

- Accounting and Regulatory Services - \$1,362,029
- Financial and Management Reporting - \$242,334
- Tax - \$737,731
- Accounting Transaction Services - \$218,286

Each category is discussed below.

Accounting and Regulatory Services - \$1,362,029

Q. PLEASE DESCRIBE THE ACCOUNTING AND REGULATORY SERVICES PROVIDED TO SWEPCO.

A. SWEPCO does not have a stand-alone accounting department. General accounting services provided to SWEPCO include maintaining the books and records of SWEPCO, preparing all monthly entries to the ledgers, and developing and maintaining the accounting and business systems that support SWEPCO. Additional accounting services provided to SWEPCO include ensuring authorization and compliance with corporate accounting policy, and monitoring SEC and Financial Accounting Standards Board rulemaking activities.

Also included in the accounting services provided are regulatory accounting services such as preparing the schedules for state filing requirements for rate cases and

1 other commission proceedings, as well as providing the witnesses in the areas of  
2 accounting, depreciation, affiliate transactions, benefit accounting, and other specialty  
3 areas.

4 Q. WHAT IS THE TREND IN COSTS BILLED TO SWEPCO BY THE ACCOUNTING  
5 AND REGULATORY SERVICES DEPARTMENT?

6 A. As shown in the table below, the accounting and regulatory services provided to  
7 SWEPCO have decreased by \$353,634 from 2017 to the current test year, primarily due  
8 to decreased headcount over that same period.

9 *Table 13*  
10 **Accounting and Regulatory Services Cost Trends**  
11 **As Billed to SWEPCO**

	2017	2018	2019	Test Year
Labor Costs	\$1,568,026	\$1,802,429	\$1,582,778	\$1,137,730
Outside Services	113,839	366,545	296,261	202,800
Other Costs	33,798	170,807	111,447	21,499
Total Services Provided	\$1,715,663	\$2,339,781	\$1,990,486	\$ 1,362,029

12 Q. PLEASE DISCUSS THE REASONABLENESS OF AFFILIATE EXPENSES FOR  
13 ACCOUNTING AND REGULATORY SERVICES AND THE BENEFITS THAT  
14 SWEPCO DERIVES FROM PROVISION OF THESE SERVICES BY AEPSC.

15 A. AEPSC provides accounting to SWEPCO on a centralized basis. Specialized  
16 accounting expertise and knowledge concerning generally accepted accounting  
17 principles, SEC and FERC rules and filing requirements, as well as specific state  
18 knowledge and requirements, is maintained and provided through one department.  
19 Providing this expertise avoids redundancy in the staffs and ensures a consistent

1 approach to complying with regulatory requirements. Additionally, AEPSC maintains  
2 in-house experts in accounting and tax who are shared by all affiliate companies and  
3 manages common financial systems to avoid the expense of several diverse systems  
4 used by each company.

5 Financial and Management Reporting - \$242,334

6 Q. PLEASE DESCRIBE THE FINANCIAL AND MANAGEMENT REPORTING  
7 SERVICES PROVIDED TO SWEPCO.

8 A. All external financial reporting for SWEPCO is done through a centralized financial  
9 reporting organization at AEPSC. The centralized organization prepares SEC and  
10 Commission financial reports, prepares and files consolidated financial statements, and  
11 monitors changes in financial reporting requirements. Also included in the financial  
12 and management reporting services provided are monthly variance reports, which are  
13 produced to assist AEPSC and the utility companies in the analysis of earnings and  
14 trends.

15 Q. WHAT IS THE TREND IN COSTS BILLED TO SWEPCO BY THE FINANCIAL  
16 AND MANAGEMENT REPORTING SERVICES DEPARTMENT?

17 A. As shown in the table below, the financial and management reporting services provided  
18 to SWEPCO have decreased by \$30,030 since 2017, which indicates a very stable level  
19 of O&M costs over the last several years.

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*Table 14*  
**Financial and Management Reporting Services Cost Trends**  
**As Billed to SWEPCO**

	2017	2018	2019	Test Year
Labor Costs	\$ 256,029	\$ 275,416	\$ 234,618	\$ 229,826
Outside Services	15,299	13,281	15,529	11,652
Other Costs	1,036	1,316	1,899	856
Total Services Provided	\$ 272,364	\$ 290,013	\$ 252,046	\$ 242,334

4 Q. PLEASE DISCUSS THE REASONABLENESS OF AFFILIATE EXPENSES FOR  
5 FINANCIAL AND MANAGEMENT REPORTING SERVICES AND THE  
6 BENEFITS THAT SWEPCO DERIVES FROM PROVISION OF THESE SERVICES  
7 BY AEPSC.

8 A. AEPSC provides specialized knowledge of the SEC and FERC rules and filing  
9 requirements, as well as specific state knowledge and requirements. Providing this  
10 expertise avoids redundancy in the staffs and ensures a consistent approach to  
11 complying with reporting requirements. Additionally, AEP files a combined SEC  
12 Form 10-K and Form 10-Q, and a combined financial reporting department is able to  
13 share knowledge and maintain consistency between company filings.

14 Of great benefit to SWEPCO is the reporting department's compliance with the  
15 Sarbanes-Oxley Act (Sarbanes). This department manages the additional Sarbanes'  
16 requirements for reporting, such as upper management and Board of Directors reviews  
17 and certifications of all SWEPCO required reports. Having one department keep  
18 current with the changing financial reporting requirements, and managing the  
19 requirements of the Sarbanes, allows SWEPCO to receive financial and management

1 reports on a timely basis, with full assurance of the accuracy and review of those  
2 reports.

3 Tax - \$737,731

4 Q. PLEASE DESCRIBE THE TAX SERVICES PROVIDED TO SWEPCO.

5 A. Tax research and consultation services are provided to SWEPCO in both state and  
6 federal tax areas, including the preparation and filing of all SWEPCO income tax  
7 returns and the administration of Internal Revenue Service, state and local  
8 examinations, protests and appeals. The AEPSC Tax department also prepares and files  
9 all state and local tax returns, such as gross receipts, franchise, property and sales tax.  
10 The Tax department further provides federal and state tax planning and payment  
11 forecasting and the monitoring of federal and state tax legislation and rulemaking  
12 activities.

13 Q. WHAT IS THE TREND IN COSTS BILLED TO SWEPCO BY THE TAX  
14 DEPARTMENT?

15 A. As shown in the table below, the tax services provided to SWEPCO have increased by  
16 \$22,830 since 2017.

17 *Table 15*  
18 **Tax Services Cost Trends**  
19 **As Billed to SWEPCO**

	2017	2018	2019	Test Year
Labor Costs	\$ 555,491	\$ 573,038	\$ 514,591	\$ 492,762
Outside Services	114,053	170,064	87,513	213,649
Other Costs	45,357	70,001	49,536	31,320
Total Services Provided	\$ 714,901	\$ 813,103	\$ 651,640	\$ 737,731

1 Q. PLEASE DISCUSS THE REASONABLENESS OF AFFILIATE EXPENSES FOR  
2 TAX SERVICES AND THE BENEFITS THAT SWEPCO DERIVES FROM  
3 PROVISION OF THESE SERVICES BY A CENTRALIZED SERVICE  
4 COMPANY.

5 A. Filing a consolidated federal income tax return, as the AEP system does, requires a  
6 coordinated approach due to the consistency required among all subsidiaries. AEPSC  
7 provides economies of scale in matters requiring tax research, planning and compliance.  
8 AEPSC's capabilities avoid redundancy in staffing at the subsidiaries and minimize the  
9 need for multiple extensive tax libraries and tax compliance software that would add to  
10 the cost of the service. AEPSC provides consultation in state and local tax  
11 administration during audits, and legislative and regulatory matters.

12 Accounting Transaction Services - \$218,286

13 Q. PLEASE DESCRIBE THE ACCOUNTING TRANSACTION SERVICES  
14 PROVIDED TO SWEPCO.

15 A. The Accounting Transaction Services groups are generally those that process high  
16 volumes of accounting information, such as customer bill payments and accounts  
17 payable invoices. Also included in the accounting processing services provided are  
18 accounts receivable, property accounting, property leasing accounting, and payroll  
19 allocations.

20 Q. WHAT IS THE TREND IN COSTS BILLED TO SWEPCO BY THE ACCOUNTING  
21 TRANSACTION SERVICES DEPARTMENT?



1 A. As shown in the table below, the accounting and transaction services provided to  
2 SWEPCO have decreased by \$418,561 since 2017, primarily due to decreased  
3 headcount over that same period.

4 *Table 16*  
5 **Accounting Transaction Services Cost Trends**  
6 **As Billed to SWEPCO**

	2017	2018	2019	Test Year
Labor Costs	\$ 553,493	\$ 594,008	\$ 225,249	\$ 194,796
Outside Services	76,734	56,588	2,855	21,067
Other Costs	6,620	23,240	3,588	2,423
Total Services Provided	\$ 636,847	\$ 673,836	231,692	\$ 218,286

7 Q. PLEASE DISCUSS THE REASONABLENESS OF AFFILIATE EXPENSES FOR  
8 ACCOUNTING TRANSACTION SERVICES AND THE BENEFITS THAT  
9 SWEPCO DERIVES FROM PROVISION OF THESE SERVICES BY AEPSC.

10 A. AEPSC uses common accounting systems, such as accounts payable, asset  
11 management, accounts receivable, and other systems to process the transactions for AEP  
12 companies. A central location for high-volume transaction processing allows the  
13 company to use one staff, provide training in one location, provide storage and filing in  
14 one location, use one bill insert process and machinery, and automated posting systems.  
15 Prior to the centralization of many of these types of services at AEPSC, these systems  
16 and the machinery were owned and operated by each operating company, resulting in  
17 more utility assets and funds being used for the services that are shared today. The  
18 sharing of one data imaging system for the storage of invoices with other affiliates by its  
19 very nature results in savings over SWEPCO owning and maintaining that same system  
20 itself.

1                                    Corporate Planning and Budgeting - \$1,216,334

2    Q.    PLEASE DESCRIBE THE CORPORATE PLANNING AND BUDGETING  
3           SERVICES PROVIDED TO SWEPCO.

4    A.    As shown in Table 9 above, SWEPCO was billed \$1,216,334 during the test year for  
5           corporate planning and budgeting.

6           Planning and budgeting provides long and short-range planning services  
7           (including services related to forecasting), strategic planning and analyses, and budget  
8           variance analyses. Financial planning provides support for a computerized financial  
9           model used to develop long-term projections and other resource planning. The financial  
10          forecasts are provided to rating agencies to assist in the evaluation of credit quality and  
11          are distributed to security analysts. The forecasts also provide data needed for  
12          regulatory reviews and other filings. Additionally, the Planning and Budgeting group  
13          manages and participates in various process improvement projects.

14   Q.    WHAT IS THE TREND IN COSTS BILLED TO SWEPCO BY THE CORPORATE  
15           PLANNING AND BUDGETING DEPARTMENT?

16   A.    As shown in the table below, the corporate planning and budgeting services provided to  
17           SWEPCO have decreased by \$151,078 since 2017, indicating a stable level of O&M  
18           costs over the past several years.

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*Table 17*  
**Corporate Planning and Budgeting Services Cost Trends**  
**As Billed to SWEPCO**

	2017	2018	2019	Test Year
Labor Costs	\$ 1,272,482	\$ 1,376,797	\$ 1,293,962	\$ 1,116,641
Outside Services	77,748	81,175	126,539	85,030
Other Costs	17,182	16,605	15,896	14,663
Total Services Provided	\$ 1,367,412	\$ 1,474,577	\$ 1,436,397	\$ 1,216,334

4 Q. PLEASE DISCUSS THE REASONABLENESS OF AFFILIATE EXPENSES FOR  
5 CORPORATE PLANNING AND BUDGETING AND THE BENEFITS THAT  
6 SWEPCO DERIVES FROM PROVISION OF THESE SERVICES BY A  
7 CENTRALIZED SERVICE COMPANY.

8 A. The benefits of a combined financial planning and budgeting service include the use of  
9 standard software packages, which permits, among other things, the timely and  
10 consistent development of consolidated AEP projections used for equity analysts.  
11 These projections facilitate the AEP system companies' access to capital to meet  
12 operating company growth requirements, and the use of a common system improves the  
13 quality and consistency of the information provided to the investment community.

14 Other standard forecasting systems for revenues and customers allow load  
15 forecasting to be performed more economically and with fewer people than if each  
16 utility company was required to maintain its own software and to have experts run the  
17 models. Forecasting for revenues, load, or the expenditure cycles is a proprietary  
18 process with an unpredictable workload, so the use of outside consultants could be  
19 expensive.

1                   Treasury and Investor Relations Services - \$1,243,127

2   Q.   PLEASE DESCRIBE THE TREASURY AND INVESTOR RELATIONS SERVICES  
3       PROVIDED TO SWEPCO.

4   A.   As shown in Table 9 above, SWEPCO was billed \$1,243,127 during the test year for  
5       treasury and investor relations services. AEPSC borrows funds in order to pay  
6       employees and purchase operating items. Since there is a lag of up to one to two  
7       months for reimbursement of expenditures from the affiliate companies, AEPSC bills  
8       its interest cost to the affiliate companies as a component of the service it provides, as  
9       was approved by the SEC under PUHCA.

10           The Treasury department further provides services to SWEPCO in the areas of  
11       cash management, corporate financing, treasury/investment management and investor  
12       relations.

13           Cash management (\$1,012,626) provides service related to the operation of  
14       the corporate borrowing program. Of this amount, approximately \$744,000 represents  
15       the SWEPCO allocation of AEPSC interest expense incurred as a component of  
16       AEPSC's normal working capital. The corporate borrowing program is the method by  
17       which SWEPCO and other AEP affiliates manage their day-to-day cash needs.  
18       SWEPCO can be either invested in, or borrowed from, the corporate program. The  
19       corporate borrowing program is supported by a series of credit lines that allows AEP  
20       to borrow funds to provide operating cash to the companies or to invest excess cash.  
21       This ensures that the use of or investment of cash assets is maximized daily.

1           Corporate financing services (\$107,435) are provided by the AEPSC  
2           Corporate Finance staff within the Treasury department. This staff conducts all  
3           financing activity for SWEPCO and the other AEP companies, including AEP, Inc.  
4           This financing activity includes the issuance of debt, equity or hybrid securities, as  
5           well as coordinating project financings. It also includes all activities related to  
6           financings such as maintaining relationships with financial institutions and rating  
7           agencies, negotiating the business terms of financing agreements, providing  
8           documentation required by financial institutions and governmental agencies such as  
9           the SEC and state regulatory agencies, ongoing monitoring of capital markets,  
10          financial modeling, analyzing financing alternatives, preparing and filing with the  
11          SEC documents required by the Securities Act of 1933 and the Securities Exchange  
12          Act of 1934.

13          Treasury/Investment management services (\$45,701) provides overall  
14          management of the treasury areas, including managing the investments for the AEP  
15          system's employee benefit plans. These plans, including the retirement savings plan,  
16          cash balance retirement plan, employees' life insurance plan and the disability income  
17          plan, have assets in external trust accounts. In addition, the Treasury staff keeps up to  
18          date on the regulatory requirements of the Department of Labor and the Internal  
19          Revenue Service for employee benefit funds covered under the Employee Retirement  
20          Income Security Act.

21          Investor relations services (\$77,365) provides present and potential investors  
22          and shareholders with an accurate portrayal of SWEPCO's financial performance and

related financial data. Providing such information can have a positive impact on the utility's bond prices and common stock, and, consequently, on its cost of capital. The investor relations function is essential to attracting and maintaining investor capital. The Investor Relations department provides disclosure and dissemination of information about the Company through formal presentations, telephone conversations with investors and Wall Street analysts, and face-to-face meetings with investors.

Q. WHAT IS THE TREND IN COSTS BILLED TO SWEPCO BY THE TREASURY AND INVESTOR RELATIONS DEPARTMENT?

A. As shown in the table below, the treasury and investor relations services provided to SWEPCO have increased by \$475,721 since 2017.

*Table 18*  
**Treasury and Investor Relations Services Cost Trends**  
**As Billed to SWEPCO**

	2017	2018	2019	Test Year
Labor Costs	\$ 375,646	\$ 400,493	\$ 357,327	\$ 352,163
Outside Services	10,671	69,538	138,884	137,502
Other Costs	381,089	584,689	786,058	753,462
Total Services Provided	\$ 767,406	\$ 1,054,720	\$ 1,282,269	\$ 1,243,127

The increase is mainly related to the AEPSC interest expense billed to SWEPCO, which is incurred as a component of AEPSC's normal working capital, and the cost of borrowing increased from 2017 to the end of the test year. This cost is allocated to the affiliates based on their share of the AEPSC bill, and SWEPCO's share of the AEPSC bill has remained relatively level over this time span.

1 Q. PLEASE DISCUSS THE REASONABLENESS OF AFFILIATE EXPENSES FOR  
2 TREASURY SERVICES AND THE BENEFITS THAT SWEPCO DERIVES FROM  
3 PROVISION OF THESE SERVICES BY A CENTRALIZED SERVICE COMPANY.

4 A. Having a centralized treasury and banking group gives all AEP member companies  
5 advantages of the high volumes generated by all companies, which results in the  
6 ability to negotiate lower per unit costs for bank transaction processing. Having a  
7 “central” relationship with the banking and finance communities can result in more  
8 competitive financing arrangements and allows the AEP companies to better manage  
9 their cash positions.

10 In terms of the investor relations group, AEP, Inc. is the publicly traded entity,  
11 and AEP in turn owns the equity shares of the utility subsidiaries. Thus, there is no  
12 reason to have multiple shareholder or investor services departments attempting to all  
13 service the same set of shareholders and investors. Having a central department  
14 allows the staff to present a united story to the market on AEP and AEP’s  
15 subsidiaries.

16 Risk and Strategic Initiatives - \$1,277,720

17 Q. WHAT ARE SWEPCO’S ADJUSTED TEST YEAR COSTS FOR RISK AND  
18 STRATEGIC INITIATIVES SERVICES PROVIDED BY AEPSC?

19 A. As shown in Table 9 above, SWEPCO was billed \$1,277,720 during the test year for  
20 risk and strategic initiatives services.

21 Q. PLEASE DESCRIBE THE RISK AND STRATEGIC INITIATIVES SERVICES  
22 THAT ARE PROVIDED TO SWEPCO BY AEPSC.

1 A. Risk and strategic initiatives services pertain to financial risk control and the  
2 provision of insurance services to affiliated companies.

3 Financial risk management services include developing and monitoring  
4 systems that track the level of financial risk inherent in company transactions and  
5 evaluating financial options.

6 Insurance services include the procurement of insurance programs to protect  
7 AEP and all of its operating companies and business units from the financial risk of  
8 accidental losses and administers the services necessary to support that task. These  
9 programs include but are not limited to property, workers' compensation, casualty,  
10 and directors and officers insurance. Insurance services also include adjusting claims  
11 made against the company for third-party bodily injury and property damage and first-  
12 party property damage and recovery on claims from damage to AEP property by  
13 outside parties.

14 Q. WHAT IS THE TREND IN COSTS BILLED TO SWEPCO BY THE RISK AND  
15 STRATEGIC INITIATIVES DEPARTMENT?

16 A. As shown in the table below, the risk and strategic initiatives services provided to  
17 SWEPCO have increased by \$60,882 since 2017, indicating a stable level of O&M  
18 costs over that same period.



*Table 19*  
**Risk and Strategic Initiatives Services Cost Trends**  
**As Billed to SWEPCO**

	2017	2018	2019	Test Year
Labor Costs	\$1,045,951	\$1,035,761	\$1,108,904	\$1,134,829
Outside Services	116,333	228,766	104,796	107,215
Other Costs	54,554	34,918	44,885	35,676
Total Services Provided	\$1,216,838	\$1,299,445	\$1,258,585	\$1,277,720

Q. ARE SWEPCO'S AFFILIATE EXPENSES FOR THE RISK AND STRATEGIC INITIATIVES SERVICES REASONABLE?

A. Yes. Insurance costs are a major cost of doing business, and AEPSC can negotiate insurance rates for the entire AEP system, which allows each operating company to enjoy lower costs than they could receive by procuring policies on a stand-alone basis. AEPSC is able to consolidate coverage for multiple affiliates under one umbrella of insurance policies and by doing so receives significant discounts. The financial risk area ensures that SWEPCO uses appropriate financial risk mitigation and monitors the Company for compliance with financial risk policies.

Other Finance Services - \$2,904,997

Q. WHAT ARE SWEPCO'S ADJUSTED TEST YEAR COSTS FOR OTHER FINANCE SERVICES PROVIDED BY AEPSC?

A. As shown in Table 9 above, SWEPCO was billed \$2,904,997 during the test year for these services. These costs include the Office of the CFO and the support personnel for the Finance division and include normal expenses such as salary, incentive, office supplies and travel expenses for the Office. The CFO provides the overall guidance to the departments discussed above, including setting overall performance goals and

1 expectations. The CFO is responsible for the compilation of the corporate strategic  
2 plans and management reporting of those plans.

3 Other components of costs in the finance class include some post-retirement  
4 benefits due to a new accounting standard that started in 2018 and pro-forma  
5 adjustments to the overall affiliate costs presented in this case (primarily related to  
6 headcount). While these items are spread throughout all departments of AEPSC, the  
7 pro-forma adjustment for this case was made on an overall AEPSC basis and included  
8 in this class of affiliate service. The pro-forma adjustments are explained earlier in my  
9 testimony.

10 *Table 20*  
11 **Chief Financial Officer Class of Service**  
12 **Other Finance Services by Category for the Test Year Ended March 31, 2020**

	<b>Amount</b>
CFO Expenses	\$ 164,373
Payroll Headcount Adjustment	3,804,876
Other Accounting Adjustments	(1,064,252)
<b>Total</b>	<b>\$2,904,997</b>

*Source: EXHIBITS BJF-18 and BJF-22*

13 Q. ARE THE SERVICES PROVIDED BY THE CFO AND HIS STAFF NECESSARY  
14 TO SWEPCO?

15 A. Yes. The oversight provided by the CFO and his staff assist in the management of all  
16 finance services that are provided to SWEPCO and is necessary in maintaining  
17 SWEPCO's books and records, preparing reports, and managing SWEPCO's capital  
18 structure. These activities are not duplicated by any employees of SWEPCO.



1 Internal Audit department also has a direct relationship to the audit committee of the  
2 AEP Board of Directors.

3 Q. WHAT ARE THE MAJOR COMPONENTS OF THE CEO'S CLASS OF SERVICE  
4 COSTS?

5 A. The CEO class of service costs are incurred in the following categories:

6 *Table 22*  
7 **Components of Chief Executive Officer Class by Cost Category**

	Labor	Outside Services	Other	Grand Total
CEO	\$ 203,363	243,465	5,354	\$ 452,182
Internal Audit	\$ 704,291	32,073	27,184	\$ 763,548
Total	\$ 907,654	275,538	32,538	\$ 1,215,730
% of Total	75%	23%	2%	100%

*Note: Does not include CEO classes supported by other Company witnesses*

*Source: W/P Frantz – 7B*

8 The majority of the CEO expenses consist of employee labor and labor related  
9 costs. The reasonableness of AEPSC's salaries, incentives, and benefits costs is  
10 discussed by Mr. Carlin.

11 Q. WHAT IS THE COST TREND FOR THE SERVICES PROVIDED BY THE CHIEF  
12 EXECUTIVE OFFICER?

13 A. The services I sponsor from the Chief Executive Officer have decreased since 2017, as  
14 shown in the table below:

15 *Table 23*  
16 **Chief Executive Officer Cost Trends**  
17 **As Billed to SWEPCO**

	2017	2018	2019	Test Year
Chief Executive Officer	\$665,028	\$290,211	\$456,757	\$452,182
Internal Audit	722,412	679,527	687,468	763,548
Total	\$1,387,440	\$969,737	\$1,144,226	\$1,215,730

*Note: Does not include CEO classes supported by other Company witnesses*